1778-2

FOREIGN INVESTORS TAX ACT OF 1966

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

EIGHTY-NINTH CONGRESS

SECOND SESSION

ON

H.R. 13103

AN ACT TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO PROVIDE EQUITABLE TAX TREATMENT FOR FOREIGN INVESTMENT IN THE UNITED STATES

AUGUST 8, 9, AND 10, 1966

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

67-485 WASHINGTON : 1966

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price 75 cents

COMMITTEE ON FINANCE

RUSSELL B. LONG, Louisiana, *Chairman*

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
ABRAHAM RIBICOFF, Connecticut
LEE METCALF, Montana

JOHN J. WILLIAMS, Delaware
FRANK CARLSON, Kansas
WALLACE F. BENNETT, Utah
CARL T. CURTIS, Nebraska
THRUSTON B. MORTON, Kentucky
EVERETT McKINLEY DIRKSEN, Illinois

TOM VAIL, *Chief Counsel*
EVELYN R. THOMPSON, *Assistant Chief Clerk*

CONTENTS

COMMUNICATIONS

ADDITIONAL INFORMATION

FOREIGN INVESTORS TAX ACT OF 1966

MONDAY, AUGUST 8, 1966

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

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

Present: Senators Long, Anderson, Talmadge, Ribicoff, Williams, Carlson, Curtis, and Dirksen.

The CHAIRMAN. The hearing will come to order.

This morning we begin 3 days of hearings on the Foreign Investors Tax Act of 1966.

In 1963 President Kennedy appointed a task force on promoting increased foreign investment in U.S. corporate securities and increased foreign financing for U.S. corporations operating abroad. It was the hope of the administration that the task force would suggest additional measures to improve the U.S. balance of payments.

The report of the task force in 1964 recommended modifications in the U.S. tax law with regard to foreign investors. Based upon these recommendations legislation was submitted to Congress in 1965. After many months of working on the recommendations, the Ways and Means Committee of the House reported H.R. 13103. It passed the House on June 15. Rather than having as its purpose the encouragement of foreign investment in the United States though, the bill passed by the House is concerned with providing taxation of nonresident aliens and foreign corporations comparable to that of U.S. individuals and corporations.

(The bill, H.R. 13103 follows:)

[H.R. 13103, 89th Cong., 2d sess.]

AN ACT To amend the Internal Revenue Code of 1954 to provide equitable tax treatment for foreign investment in the United States

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE, ETC.

(a) SHORT TITLE.—This Act may be cited as the "Foreign Investors Tax Act of 1966".

(2) TABLE OF CONTENTS.—

(c) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference is to a section or other provision of the Internal Revenue Code of 1954.

SEC. 2. SOURCE OF INCOME.

(a) INTEREST.—

(1)(A) Subparagraph (A) of section 861(a)(1) (relating to interest from sources within the United States) is amended to read as follows:

"(A) interest on amounts described in subsection (c) received by a nonresident alien individual or a foreign corporation, if such interest is not effectively connected with the conduct of a trade or business within the United States,".

(B) Section 861 is amended by adding at the end thereof the following new subsection:

"(c) INTEREST ON DEPOSITS, ETC.—For purposes of subsection (a)(1)(A), the amounts described in this subsection are—

"(1) deposits with persons carrying on the banking business,

"(2) deposits or withdrawable accounts with savings institutions chartered and supervised as savings and loan or similar association under Federal or State law, but only to the extent that amounts paid or credited on such deposits or accounts are deductible under section 591 in computing the taxable income of such institutions, and

"(3) amounts held by an insurance company under an agreement to pay interest thereon.

Effective with respect to amounts paid or credited after December 31, 1971, subsection (a)(1)(A) and this subsection shall cease to apply."

(2) Section 861(a)(1) is amended by striking out "and" at the end of subparagraph (B), by striking out the period at the end of subparagraph (C) and inserting in lieu thereof ", and", and by adding at the end thereof the following new subparagraph:

"(D) interest on deposits with a foreign branch of a domestic corporation, if such branch is engaged in the commercial banking business."

(3)(A) Section 895 (relating to income derived by a foreign central bank of issue from obligations of the United States) is amended—

(i) by striking out "shall not be included" and inserting in lieu thereof ", or from interest on deposits with persons carrying on the banking business, shall not be included";

(ii) by striking out "such obligations" and inserting in lieu thereof "such obligations or deposits";

(iii) by adding at the end thereof the following new sentence: "For purposes of the preceding sentence, the Bank for International Settlements shall be treated as a foreign central bank of issue with respect to interest on deposits with persons carrying on the banking business."; and

(iv) by striking out the heading and inserting in lieu thereof the following:

"SEC. 895. INCOME DERIVED BY A FOREIGN CENTRAL BANK OF ISSUE FROM OBLIGATIONS OF THE UNITED STATES OR FROM BANK DEPOSITS."

(B) The table of sections for subpart C of part II of subchapter N of chapter 1 is amended by striking out the item relating to section 895 and inserting in lieu thereof the following:

"Sec. 895. Income derived by a foreign central bank of issue from obligations of the United States or from bank deposits."

(b) DIVIDENDS.—

(1) Section 861(a)(2)(B) (relating to dividends from sources within the United States) is amended to read as follows:

"(B) from a foreign corporation unless less than 80 percent of the gross income from all sources of such foreign corporation for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was effectively connected with the conduct of a trade or business within the United States; but only in an amount which bears the same ratio to such dividends as the gross income of the corporation for such period which is effectively connected with the conduct of a trade or business within the United States bears to its gross income from all sources; but dividends from a foreign corporation shall, for purposes of subpart A of part III (relating to foreign tax credit), be treated as income from sources without the United States to the extent (and only to the extent) exceeding the amount which is 100/85ths of the amount of the deduction allowable under section 245 in respect of such dividends, or".

(2) Section 861(a)(2) is amended by adding after subparagraph (C) the following:

"For purposes of subparagraph (B), the gross income of the foreign corporation for any period before the first taxable year beginning after December 31, 1966, which is effectively connected with the conduct of a trade or business within the United States is an amount equal to the gross income for such period from sources within the United States."

(c) PERSONAL SERVICES.—Section 861(a)(3)(C)(ii) (relating to income from personal services) is amended to read as follows:

"(ii) an individual who is a citizen or resident of the United States, a domestic partnership, or a domestic corporation, if such labor or services are performed for an office or place of business maintained in a foreign country or in a possession of the United States by such individual, partnership, or corporation."

(d) DEFINITIONS.—Section 864 (relating to definitions) is amended—

(1) by striking out "For purposes of this part," and inserting in lieu thereof

"(a) SALE, ETC.—For purposes of this part,"; and

(2) by adding at the end thereof the following new subsections:

"(b) TRADE OR BUSINESS WITHIN THE UNITED STATES.—For purposes of this part, part II, and chapter 3, the term 'trade or business within the United States' includes the performance of personal services within the United States at any time within the taxable year, but does not include—

"(1) PERFORMANCE OF PERSONAL SERVICES FOR FOREIGN EMPLOYERS.—The performance of personal services—

"(A) for a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, or

"(B) for an office or place of business maintained in a foreign country or in a possession of the United States by an individual who is a citizen or resident of the United States or by a domestic partnership or a domestic corporation,

by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year and whose compensation for such services does not exceed in the aggregate $3,000.

"(2) TRADING IN SECURITIES OR COMMODITIES.—

"(A) STOCKS AND SECURITIES.—

"(i) Except in the case of a dealer in stocks or securities, trading in stocks or securities for the taxpayer's own account, whether by the taxpayer or his employees or through a resident broker, commission agent, custodian, or other agent, and whether or not any such agent has discretionary authority to make decesions in effecting the transactions. This clause shall not apply in the case of a corporation (other than a corporation which is, or but for section 542(c)(7) would be, a personal holding company) the principal business of which is trading in stocks or securities for its own account, if its principal office is in the United States.

"(ii) In the case of a person who is a dealer in stocks or securities, trading in stocks or securities for his own account through a resident broker, commission agent, custodian, or other independent agent.

"(B) COMMODITIES.—

"(i) Except in the case of a dealer in commodities, trading in commodities for the taxpayer's own account, whether by the taxpayer or his employees or through a resident broker, commission agent, custodian, or other agent, and whether or not any such agent has discretionary authority to make decisions in effecting the transactions.

"(ii) In the case of a person who is a dealer in commodities, trading in commodities for his own account through a resident broker, commission agent, custodian, or other independent agent.

"(iii) Clauses (i) and (ii) apply only if the commodities are of a kind customarily dealt in on an organized commodity exchange and if the transaction is of a kind customarily consummated at such place.

"(C) LIMITATION.—Subparagraphs (A)(ii) and (B)(ii) shall apply only if, at no time during the taxable year, the taxpayer has an office or place of business in the United States through which or by the direction of which the transactions in stocks or securities, or in commodities, as the case may be, are effected.

"(c) EFFECTIVELY CONNECTED INCOME, ETC.—

"(1) GENERAL RULE.—For purposes of this title—

"(A) In the case of a nonresident alien individual or a foreign corporation engaged in trade or business within the United States during the taxable year, the rules set forth in paragraphs (2), (3), and (4) shall apply in determining the income, gain, or loss which shall be treated as effectively connected with the conduct of a trade or business with the United States.

"(B) Except as provided in section 871(d) or section 882(d), in the case of a nonresident alien individual or a foreign corporation not engaged in trade or business within the United States during the taxable year, no income, gain, or loss shall be treated as effectively connected with the conduct of a trade or business within the United States.

"(2) PERIODICAL, ETC., INCOME FROM SOURCES WITHIN UNITED STATES—FACTORS.—In determining whether income from sources within the United States of the types described in section 871(a)(1) or section 881(a), or whether gain or loss from sources within the United States from the sale or exchange of capital assets, is effectively connected with the conduct of a trade or business within the United States, the factors taken into account shall include whether—

"(A) the income, gain, or loss is derived from assets used in or held for use in the conduct of such trade or business, or

"(B) the activities of such trade or business were a material factor in the realization of the income, gain, or loss.

In determining whether an asset is used in or held for use in the conduct of such trade or business or whether the activities of such trade or business were a material factor in realizing an item of income, gain, or loss, due regard shall be given to whether or not such asset or such income, gain, or loss was accounted for through such trade or business. In applying this paragraph and paragraph (4), interest referred to in section 861(a)(1)(A) shall be considered income from sources within the United States.

"(3) OTHER INCOME FROM SOURCES WITHIN UNITED STATES.—All income, gain, or loss from sources within the United States (other than income, gain, or loss to which paragraph (2) applies) shall be treated as effectively connected with the conduct of a trade or business within the United States.

"(4) INCOME FROM SOURCES WITHOUT UNITED STATES.—

"(A) Except as provided in subparagraph (B) and (C), no income, gain, or loss from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States.

"(B) Income, gain, or loss from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States by a nonresident alien individual or a foreign corporation if such person has an office or other fixed place of business within the United States to which such income, gain, or loss is attributable and such income, gain, or loss—

"(i) consists of rents or royalties for the use of or for the privilege of using intangible property described in section 862(a)(4) (including any gain or loss realized on the sale of such property) derived in the active conduct of such trade or business;

"(ii) consists of dividends or interest, or gain or loss from the sale or exchange of stock or notes, bonds, or other evidences of indebtedness, and either is derived in the active conduct of a banking, financing, or similar business within the United States or is received by a corporation the principal business of which is trading in stock or securities for its own account; or

"(iii) is derived from the sale (without the United States) through such office or fixed place of business of personal property described in section 1221(1), except that this clause shall not apply if the property is sold for use, consumption, or disposition outside the United States and an office or other fixed place of business of the taxpayer outside the United States participated materially in such sale.

In the case of a sale described in clause (iii), the income which shall be treated as attributable to the office or other fixed place of business within the United States shall not exceed the income which would be derived from sources within the United States if the sale were made in the United States.

"(C) In the case of a foreign corporation taxable under part I of subchapter L, any income from sources without the United States which is attributable to its United States business shall be treated as effectively connected with the conduct of a trade or business within the United States.

"(D) No income, gain, or loss from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States if it either—

"(i) consist of dividends, interest, or royalties paid by a foreign corporation in which the taxpayer owns (within the meaning of section 958(a)), or is considered as owning (by applying the ownership rules of section 958(b)), more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or

"(ii) is subpart F income within the meaning of section 952(a)."

(e) EFFECTIVE DATES.—

(1) The amendments made by subsections (a), (c), and (d) shall apply with respect to taxable years beginning after December 31, 1966; except that in applying section 864(c)(4)(B)(iii) of the Internal Revenue Code of 1954 (as added by subsection (d)) with respect to a binding contract entered into on or before February 24, 1966, activities in the United States on or before such date in negotiating or carrying out such contract shall not be taken into account.

(2) The amendments made by subsection (d) shall apply with respect to amounts received after December 31, 1966.

SEC. 3. NONRESIDENT ALIEN INDIVIDUALS.

(a) TAX ON NONRESIDENT ALIEN INDIVIDUALS.—

(1) Section 871 (relating to tax on nonresident alien individuals) is amended to read as follows:

"SEC. 871. TAX ON NONRESIDENT ALIEN INDIVIDUALS.

"(a) INCOME NOT CONNECTED WITH UNITED STATES BUSINESS—30 PERCENT TAX.—

"(1) INCOME OTHER THAN CAPITAL GAINS.—There is hereby imposed for each taxable year a tax of 30 percent of the amount received from sources within the United States by a nonresident alien individual as—

"(A) interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income,

"(B) gains described in section 402(a)(2), 403(a)(2), or 631 (b) or (c), and gains on transfers described in section 1235, and

"(C) amounts which under section 341, or under section 1232 (in the case of bonds or other evidences of indebtedness issued after September 28, 1965), are treated as gains from the sale or exchange of property which is not a capital asset,

but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States.

"(2) CAPITAL GAINS OF ALIENS PRESENT IN THE UNITED STATES 183 DAYS OR MORE.—In the case of a nonresident alien individual present in the United States for a period or periods aggregating 183 days or more during the taxable year, there is hereby imposed for such year a tax of 30 percent of the amount by which his gains, derived from sources within the United States, from the sale or exchange at any time during such year of capital assets exceed his losses, allocable to sources within the United States, from the sale or exchange at any time during such year of capital assets. For purposes of this paragraph, gains and losses shall be taken into account only if, and to the extent that, they would be recognized and taken into account if such gains and losses were effectively connected with the conduct of a trade or business within the United States, except that such gains and losses shall be determined without regard to section 1202 (relating to deduction for capital gains) and such losses shall be determined without the benefits of the capital loss carryover provided in section 1212. Any gain or loss which is taken into account in determining the tax under paragraph (1) or subsection (b) shall not be taken into account in determining the tax under this paragraph. For purposes of the 183-day requirement of this paragraph, a nonresident alien individual not engaged in trade or business within the United States who has not established a taxable year for any prior period shall be treated as having a taxable year which is the calendar year.

"(b) INCOME CONNECTED WITH UNITED STATES BUSINESS—GRADUATED RATE OF TAX.—

"(1) IMPOSITION OF TAX.—A nonresident alien individual engaged in trade or business within the United States during the taxable year shall be taxable as provided in section 1 or 1201(b) on his taxable income which is effectively connected with the conduct of a trade or business within the United States.

"(2) DETERMINATION OF TAXABLE INCOME.—In determining taxable income for purposes of paragraph (1), gross income includes only gross income which is effectively connected with the conduct of a trade or business within the United States.

"(c) PARTICIPANTS IN CERTAIN EXCHANGE OR TRAINING PROGRAMS—For purposes of this section, a nonresident alien individual who (without regard to this subsection) is not engaged in trade or business within the United States and who is temporarily present in the United States as a nonimmigrant under subparagraph (F) or (J) of section 101(a)(15) of the Immigration and Nationality Act, as amended (8 U.S.C. 1101(a)(15) (F) or (J)), shall be treated as a nonresident alien individual engaged in trade or business within the

United States, and any income described in section 1441(b) (1) or (2) which is received by such individual shall, to the extent derived from sources within the United States, be treated as effectively connected with the conduct of a trade or business within the United States.

"(d) ELECTION TO TREAT REAL PROPERTY INCOME AS INCOME CONNECTED WITH UNITED STATES BUSINESS.—

"(1) IN GENERAL.—A nonresident alien individual who during the taxable year derives any income—

"(A) from real property held for the production of income and located in the United States, or from any interest in such real property, including (i) gains from the sale or exchange of such real property or an interest therein, (ii) rents or royalties from mines, wells, or other natural deposits, and (iii) gains described in section 631 (b) or (c), and

"(B) which, but for this subsection, would not be treated as income which is effectively connected with the conduct of a trade or business within the United States,

may elect for such taxable year to treat all such income as income which is effectively connected with the conduct of a trade or business within the United States. In such case, such income shall be taxable as provided in subsection (b)(1) whether or not such individual is engaged in trade or business within the United States during the taxable year. An election under this paragraph for any taxable year shall remain in effect for all subsequent taxable years, except that it may be revoked with the consent of the Secretary or his delegate with respect to any taxable year.

"(2) ELECTION AFTER REVOCATION.—If an election has been made under paragraph (1) and such election has been revoked, a new election may not be made under such paragraph for any taxable year before the 5th taxable year which begins after the first taxable year for which such revocation is effective, unless the Secretary or his delegate consents to such new election.

"(3) FORM AND TIME OF ELECTION AND REVOCATION.—An election under paragraph (1), and any revocation of such an election, may be made only in such manner and at such time as the Secretary or his delegate may by regulations prescribe.

"(e) CROSS REFERENCES.—

"(1) For tax treatment of certain amounts distributed by the United States to nonresident alien individuals, see section 402(a)(4).

"(2) For taxation of nonresident alien individuals who are expatriate United States citizens, see section 877.

"(3) For doubling of tax on citizens of certain foreign countries, see section 891.

"(4) For reinstatement of pre-1967 income tax provisions in the case of residents of certain foreign countries, see section 896.

"(5) For withholding of tax at source on nonresident alien individuals, see section 1441.

"(6) For the requirement of making a declaration of estimated tax by certain nonresident alien individuals, see section 6015(i).

"(7) For taxation of gains realized upon certain transfers to domestic corporations, see section 1250(d)(3)."

(2) Section 1 (relating to tax on individuals) is amended by redesignating subsection (d) as subsection (e), and by inserting after subsection (c) the following new subsection:

"(d) NONRESIDENT ALIENS.—In the case of a nonresident alien individual, the tax imposed by subsection (a) shall apply only as provided by section 871 or 877."

(b) GROSS INCOME.—

(1) Subsection (a) of section 872 (relating to gross income of nonresident alien individuals) is amended to read as follows:

"(a) GENERAL RULE.—In the case of a nonresident alien individual, gross income includes only—

"(1) gross income which is derived from sources within the United States and which is not effectively connected with the conduct of a trade or business within the United States, and

"(2) gross income which is effectively connected with the conduct of a trade or business within the United States."

(2) Subparagraph (B) of section 872(b)(3) (relating to compensation of participants in certain exchange or training programs) is amended by striking out "by a domestic corporation" and inserting in lieu thereof "by a

domestic corporation, a domestic partnership, or an individual who is a citizen or resident of the United States".

(3) Subsection (b) of section 872 (relating to exclusions from gross income) is amended by adding at the end thereof the following new paragraph:

"(4) BOND INTEREST OF RESIDENTS OF THE RYUKYU ISLANDS OR THE TRUST TERRITORY OF THE PACIFIC ISLANDS.—Income derived by a nonresident alien individual from a series E or series H United States savings bond, if such individual acquired such bond while a resident of the Ryukyu Islands or the Trust Territory of the Pacific Island."

(c) DEDUCTIONS.—

(1) Section 873 (relating to deductions allowed to nonresident alien individuals) is amended to read as follows:

"SEC. 873. DEDUCTIONS.

"(a) GENERAL RULE.—In the case of a nonresident alien individual, the deductions shall be allowed only for purposes of section 871(b) and (except as provided by subsection (b)) only if and to the extent that they are connected with income which is effectively connected with the conduct of a trade or business within the United States; and the proper apportionment and allocation of the deductions for this purpose shall be determined as provided in regulations prescribed by the Secretary or his delegate.

"(b) EXCEPTIONS.—The following deductions shall be allowed whether or not they are connected with income which is effectively connected with the conduct of a trade or business within the United States:

"(1) LOSSES.—The deduction, for losses of property not connected with the trade or business if arising from certain casualties or theft, allowed by section 165(c)(3), but only if the loss is of property located within the United States.

"(2) CHARITABLE CONTRIBUTIONS.—The deduction for charitable contributions and gifts allowed by section 170.

"(3) PERSONAL EXEMPTION.—The deduction for personal exemptions allowed by section 151, except that in the case of a nonresident alien individual who is not a resident of a contiguous country only one exemption shall be allowed under section 151.

"(c) CROSS REFERENCES.—

"(1) For disallowance of standard deduction, see section 142(b)(1).

"(2) For rule that certain foreign taxes are not to be taken into account in determining deduction or credit, see section 906(b)(1)."

(2) Section 154(3) (relating to cross references in respect of deductions for personal exemptions) is amended to read as follows:

"(3) For exemptions of nonresident aliens, see section 873(b)(3)."

(d) ALLOWANCE OF DEDUCTIONS AND CREDITS.—Subsection (a) of section 874 (relating to filing of returns) is amended to read as follows:

"(a) RETURN PREREQUISITE TO ALLOWANCE.—A nonresident alien individual shall receive the benefit of the deductions and credits allowed to him in this subtitle only by filing or causing to be filed with the Secretary or his delegate a true and accurate return, in the manner prescribed in subtitle F (sec. 6001 and following, relating to procedure and administration), including therein all the information which the Secretary or his delegate may deem necessary for the calculation of such deductions and credits. This subsection shall not be construed to deny the credits provided by sections 31 and 32 for tax withheld at source or the credit provided by section 39 for certain uses of gasoline and lubricating oil."

(e) EXPATRIATION TO AVOID TAX.—

(1) Subpart A of part II of subchapter N of chapter 1 (relating to nonresident alien individuals) is amended by redesignating section 877 as section 878, and by inserting after section 876 the following new section:

"SEC. 877. EXPATRIATION TO AVOID TAX.

"(a) IN GENERAL.—Every nonresident alien individual who at any time after March 8, 1965, and within the 5-year period immediately preceding the close of the taxable year lost United States citizenship, unless such loss did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle B, shall be taxable for such taxable year in the manner provided in subsection (b) if the tax imposed pursuant to such subsection exceeds the tax which, without regard to this section, is imposed pursuant to section 871.

"(b) ALTERNATIVE TAX.—A nonresident alien individual described in subsection (a) shall be taxable for the taxable year as provided in section 1 or section 1201(b), except that—

"(1) the gross income shall include only the gross income described in section 872(a) (as modified by subsection (c) of this section), and

"(2) the deductions shall be allowed if and to the extent that they are connected with the gross income included under this section, except that the capital loss carryover provided by section 1212(b) shall not be allowed; and the proper allocation and apportionment of the deductions for this purpose shall be determined as provided under regulations prescribed by the Secretary or his delegate.

For purposes of paragraph (2), the deductions allowed by section 873(b) shall be allowed; and the deduction (for losses not connected with the trade or business if incurred in transactions entered into for profit) allowed by section 165(c)(2) shall be allowed, but only if the profit, if such transaction had resulted in a profit, would be included in gross income under this section.

"(c) SPECIAL RULES OF SOURCE.—For purposes of subsection (b), the following items of gross income shall be treated as income from sources within the United States:

"(1) SALE OF PROPERTY.—Gains on the sale or exchange of property (other than stock or debt obligations) located in the United States.

"(2) STOCK OR DEBT OBLIGATIONS.—Gains on the sale or exchange of stock issued by a domestic corporation or debt obligations of United States persons or of the United States, a State or political subdivision thereof, or the District of Columbia.

"(d) EXCEPTION FOR LOSS OF CITIZENSHIP FOR CERTAIN CAUSES.—Subsection (a) shall not apply to a nonresident alien individual whose loss of United States citizenship resulted from the application of section 301(b), 350, or 355 of the Immigration and Nationality Act, as amended (8 U.S.C. 1401(b), 1482, or 1487).

"(e) BURDEN OF PROOF.—If the Secretary or his delegate establishes that it is reasonable to believe that an individual's loss of United States citizenship would, but for this section, result in a substantial reduction for the taxable year in the taxes on his probable income for such year, the burden of proving for such taxable year that such loss of citizenship did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle B shall be on such individual."

(2) The table of sections for subpart A of part II of subchapter N of chapter 1 (relating to nonresident alien individuals) is amended by striking out the item relating to section 877 and inserting in lieu thereof the following:

"Sec. 877. Expatriation to avoid tax.
"Sec. 878. Foreign educational, charitable, and certain other exempt organizations."

(f) PARTIAL EXCLUSION OF DIVIDENDS.—Subsection (d) of section 116 (relating to certain nonresident aliens ineligible for exclusion) is amended to read as follows:

"(d) CERTAIN NONRESIDENT ALIENS INELIGIBLE FOR EXCLUSION.—In the case of a nonresident alien individual, subsection (a) shall apply only—

"(1) in determining the tax imposed for the taxable year pursuant to section 871(b)(1) and only in respect of dividends which are effectively connected with the conduct of a trade or business within the United States, or

"(2) in determining the tax imposed for the taxable year pursuant to section 877(b)."

(g) WITHHOLDING OF TAX ON NONRESIDENT ALIENS.—Section 1441 (relating to withholding of tax on nonresident aliens) is amended—

(1) by striking out "(except interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States)" in subsection (b);

(2) by striking out "and amounts described in section 402(a)(2)" and all that follows in the first sentence of subsection (b) and inserting in lieu thereof "and gains described in section 402(a)(2), 403(a)(2), or 631(b) or (c), and gains on transfers described in section 1235.";

(3) by striking out paragraph (1) of subsection (c) and inserting in lieu thereof the following new paragraph:

"(1) INCOME CONNECTED WITH UNITED STATES BUSINESS.—No deduction or withholding under subsection (a) shall be required in the case of any item of income (other than compensation for personal services) which is effectively connected with the conduct of a trade or business within the United States and on which a tax is imposed for the taxable year pursuant to section 871(b)(1).";

(4) by amending paragraph (4) of subsection (c) to read as follows:

"(4) COMPENSATION OF CERTAIN ALIENS.—Under regulations prescribed by the Secretary or his delegate, compensation for personal services may be exempted from deduction and withholding under subsection (a)."; and

(5) by striking out "amounts described in section 402(a)(2), section 403(a)(2), section 631 (b) and (c), and section 1235, which are considered to be gains from the sale or exchange of capital assets," in paragraph (5) of subsection (c) and inserting in lieu thereof "gains described in section 402(a)(2), 403(a)(2), or 631 (b) or (c), and gains on transfers described in section 1235,", and by striking out "proceeds from such sale or exchange," in such paragraph and inserting in lieu thereof "amount payable,".

(h) LIABILITY FOR WITHHELD TAX.—Section 1461 (relating to return and payment of withheld tax) is amended to read as follows:

"SEC. 1461. LIABILITY FOR WITHHELD TAX.

"Every person required to deduct and withhold any tax under this chapter is hereby made liable for such tax and is hereby indemnified against the claims and demands of any person for the amount of any payments made in accordance with the provisions of this chapter."

(i) DECLARATION OF ESTIMATED INCOME TAX BY INDIVIDUALS.—Section 6015 (relating to declaration of estimated income tax by individuals) is amended—

(1) by striking out that portion of subsection (a) which precedes paragraph (1) and inserting in lieu thereof the following:

"(a) REQUIREMENT OF DECLARATION.—Except as otherwise provided in subsection (i), every individual shall make a declaration of his estimated tax for the taxable year if—";

(2) by redesignating subsection (i) as subsection (j); and

(3) by inserting after subsection (h) the following new subsection:

"(i) NONRESIDENT ALIEN INDIVIDUALS.—No declaration shall be required to be made under this section by a nonresident alien individual unless—

"(1) withholding under chapter 24 is made applicable to the wages, as defined in section 3401(a), of such individual,

"(2) such individual has income (other than compensation for personal services subject to deduction and withholding under section 1441) which is effectively connected with the conduct of a trade or business within the United States, or

"(3) such individual is a resident of Puerto Rico during the entire taxable year."

(j) GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE REALTY.—The second sentence of paragraph (3) of section 1250(d) (relating to certain tax-free transactions) is amended to read as follows: "This paragraph shall not apply to—

"(A) a disposition to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by this chapter, or

"(B) a transfer of property by a nonresident alien individual, a foreign estate or trust, or a foreign partnership, to a domestic corporation in exchange for stock or securities in such corporation in a transaction to which section 351 applies."

(k) COLLECTION OF INCOME TAX AT SOURCE ON WAGES.—Subsection (a) of section 3401 (relating to definition of wages for purposes of collection of income tax at source) is amended by striking out paragraphs (6) and (7) and inserting in lieu thereof the following:

"(6) for such services, performed by a nonresident alien individual, as may be designated by regulations prescribed by the Secretary or his delegate; or".

(l) DEFINITION OF FOREIGN ESTATE OR TRUST.—Section 7701(a)(31) (defining foreign estate or trust) is amended by striking out "from sources without the United States" and inserting in lieu thereof ", from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States,".

(m) CONFORMING AMENDMENT.—The first sentence of section 932(a) (relating to citizens of possessions of the United States) is amended to read as follows: "Any individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United States shall be subject to taxation under this subtitle in the same manner and subject to the same conditions as in the case of a nonresident alien individual."

(n) EFFECTIVE DATES.—

(1) The amendments made by this section (other than the amendments made by subsections (h) and (k)) shall apply with respect to taxable years beginning after December 31, 1966.

(2) The amendments made by subsection (h) shall apply with respect to payments occurring after December 31, 1966.

(3) The amendments made by subsection (k) shall apply with respect to remuneration paid after December 31, 1966.

SEC. 4. FOREIGN CORPORATIONS.

(a) TAX ON INCOME NOT CONNECTED WITH UNITED STATES BUSINESS.—Section 881 (relating to tax on foreign corporations not engaged in business in the United States) is amended to read as follows:

"SEC. 881. INCOME OF FOREIGN CORPORATIONS NOT CONNECTED WITH UNITED STATES BUSINESS.

"(a) IMPOSITION OF TAX.—There is hereby imposed for each taxable year a tax of 30 percent of the amount received from sources within the United States by a foreign corporation as—

"(1) interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income,

"(2) gains described in section 631(b) or (c), and

"(3) amounts which under section 341, or under section 1232 (in the case of bonds or other evidences of indebtedness issued after September 28, 1965), are treated as gains from the sale or exchange of property which is not a capital asset,

but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States.

"(b) DOUBLING OF TAX.—

"For doubling of tax on corporations of certain foreign countries, see section 891."

(b) TAX ON INCOME CONNECTED WITH UNITED STATES BUSINESS.—

(1) Section 882 (relating to tax on resident foreign corporations) is amended to read as follows:

"SEC. 882. INCOME OF FOREIGN CORPORATIONS CONNECTED WITH UNITED STATES BUSINESS.

"(a) NORMAL TAX AND SURTAX.—

"(1) IMPOSITION OF TAX.—A foreign corporation engaged in trade or business within the United States during the taxable year shall be taxable as provided in section 11 or 1201(a) on its taxable income which is effectively connected with the conduct of a trade or business within the United States.

"(2) DETERMINATION OF TAXABLE INCOME.—In determining taxable income for purposes of paragraph (1), gross income includes only gross income which is effectively connected with the conduct of a trade or business within the United States.

"(b) GROSS INCOME.—In the case of a foreign corporation, gross income includes only—

"(1) gross income which is derived from sources within the United States and which is not effectively connected with the conduct of a trade or business within the United States, and

"(2) gross income which is effectively connected with the conduct of a trade or business within the United States.

"(c) ALLOWANCE OF DEDUCTIONS AND CREDITS.—

"(1) ALLOCATION OF DEDUCTIONS—

"(A) GENERAL RULE.—In the case of a foreign corporation, the deductions shall be allowed only for purposes of subsection (a) and (except as provided by subparagraph (B)) only if and to the extent that they are connected with income which is effectively connected with the conduct of a trade or business within the United States; and the proper apportionment and allocation of the deductions for this purpose shall be determined as provided in regulations prescribed by the Secretary or his delegate.

"(B) CHARITABLE CONTRIBUTIONS.—The deduction for charitable contributions and gifts provided by section 170 shall be allowed whether or not connected with income which is effectively connected with the conduct of a trade or business within the United States.

"(2) DEDUCTIONS AND CREDITS ALLOWED ONLY IF RETURN FILED.—A foreign corporation shall receive the benefit of the deductions and credits allowed to it in this subtitle only by filing or causing to be filed with the Secretary or his delegate a true and accurate return, in the manner prescribed in subtitle F, including therein all the information which the Secretary or his delegate may deem necessary for the calculation of such deductions and credits. This paragraph shall not be construed to deny the credit provided by section 32 for tax withheld at source or the credit provided by section 39 for certain uses of gasoline and lubricating oil.

"(3) FOREIGN TAX CREDIT.—Except as provided by section 906, foreign corporations shall not be allowed the credit against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

"(4) CROSS REFERENCE.—

"For rule that certain foreign taxes are not to be taken into account in determining deduction or credit, see section 906(b)(1).

"(d) ELECTION TO TREAT REAL PROPERTY INCOME AS INCOME CONNECTED WITH UNITED STATES BUSINESS.—

"(1) IN GENERAL.—A foreign corporation which during the taxable year derives any income—

"(A) from real property located in the United States, or from any interest in such real property, including (i) gains from the sale or exchange of real property or an interest therein, (ii) rents or royalties from mines, wells, or other natural deposits, and (iii) gains described in section 631 (b) or (c), and

"(B) which, but for this subsection, would not be treated as income effectively connected with the conduct of a trade or business within the United States,

may elect for such taxable year to treat all such income as income which is effectively connected with the conduct of a trade or business within the United States. In such case, such income shall be taxable as provided in subsection (a)(1) whether or not such corporation is engaged in trade or business within the United States during the taxable year. An election under this paragraph for any taxable year shall remain in effect for all subsequent taxable years, except that it may be revoked with the consent of the Secretary or his delegate with respect to any taxable year.

"(2) ELECTION AFTER REVOCATION, ETC.—Paragraphs (2) and (3) of section 871(d) shall apply in respect of elections under this subsection in the same manner and to the same extent as they apply in respect of elections under section 871(d).

"(e) RETURNS OF TAX BY AGENT.—If any foreign corporation has no office or place of business in the United States but has an agent in the United States, the return required under section 6012 shall be made by the agent."

(2)(A) Subsection (e) of section 11 (relating to exceptions from tax on corporations) is amended by inserting "or" at the end of paragraph (2), by striking out ", or" at the end of paragraph (3) and inserting a period in lieu thereof, and by striking out paragraph (4).

(B) Section 11 (relating to tax on corporations) is amended by adding at the end thereof the following new subsection:

"(f) FOREIGN CORPORATIONS.—In the case of a foreign corporation, the tax imposed by subsection (a) shall apply only as provided by section 882."

(3) The table of sections for subpart B of part II of subchapter N of chapter 1 is amended by striking out the items relating to sections 881 and 882 and inserting in lieu thereof the following:

"Sec. 881. Income of foreign corporations not connected with United States business.

"Sec. 882. Income of foreign corporations connected with United States business."

(c) WITHHOLDING OF TAX ON FOREIGN CORPORATIONS.—Section 1442 (relating to withholding of tax on foreign corporations) is amended to read as follows:

"SEC. 1442. WITHHOLDING OF TAX ON FOREIGN CORPORATIONS.

"(a) GENERAL RULE.—In the case of foreign corporations subject to taxation under this subtitle, there shall be deducted and withheld at the source in the same manner and on the same items of income as is provided in section 1441 or section 1451 a tax equal to 30 percent thereof; except that, in the case of interest described in section 1451 (relating to tax-free covenant bonds), the deduction and withholding shall be at the rate specified therein. For purposes of the preceding sentence, the reference in section 1441(c)(1) to section 871(b)(1) shall be treated as referring to section 842 or section 882 (a) as the case may be.

"(b) EXEMPTION.—Subject to such terms and conditions as may be provided by regulations prescribed by the Secretary or his delegate, subsection (a) shall not apply in the case of a foreign corporation engaged in trade or business within the United States if the Secretary or his delegate determines that the requirements of subsection (a) imposes an undue administrative burden and that the collection of the tax imposed by section 881 on such corporation will not be jeopardized by the exemption."

(d) DIVIDENDS RECEIVED FROM CERTAIN FOREIGN CORPORATIONS.—Subsection (a) of section 245 (relating to the allowance of a deduction in respect of dividends received from a foreign corporation) is amended—

(1) by striking out "and has derived 50 percent or more of its gross income from sources within the United States," in that portion of subsection (a) which precedes paragraph (1) and by inserting in lieu thereof "and if 50 percent or more of the gross income of such corporation from all sources for such period is effectively connected with the conduct of a trade or business within the United States,";

(2) by striking out "from sources within the United States" in paragraph (1) and inserting in lieu thereof "which is effectively connected with the conduct of a trade or business within the United States";

(3) by striking out "from sources within the United States" in paragraph (2) and inserting in lieu thereof ", which is effectively connected with the conduct of a trade or business within the United States,"; and

(4) by adding after paragraph (2) the following new sentence:

"For purposes of this subsection, the gross income of the foreign taxable corporation for any period before the first taxable year beginning after December 31, 1966, which is effectively connected with the conduct of a trade or business within the United States is an amount equal to the gross income for such period from sources within the United States."

(e) UNRELATED BUSINESS TAXABLE INCOME.—The last sentence of section 512 (a) (relating to definition) is amended to read as follows: "In the case of an organization described in section 511 which is a foreign organization, the unrelated business taxable income shall be its unrelated business taxable income which is effectively connected with the conduct of a trade or business within the United States."

(f) CORPORATIONS SUBJECT TO PERSONAL HOLDING COMPANY TAX.—Paragraph (7) of section 542(c) (relating to corporations not subject to the personal holding company tax) is amended to read as follows:

"(7) a foreign corporation, if all of its stock outstanding during the last half of the taxable year is owned by nonresident alien individuals, whether directly or indirectly through foreign estates, foreign trusts, foreign partnerships, or other foreign corporations;".

(g) AMENDMENTS WITH RESPECT TO FOREIGN CORPORATIONS CARRYING ON INSURANCE BUSINESS IN UNITED STATES.—

(1) Section 842 (relating to computation of gross income) is amended to read as follows:

"SEC. 842. FOREIGN CORPORATIONS CARRYING ON INSURANCE BUSINESS.

"If a foreign corporation carrying on an insurance business within the United States would qualify under part I, II, or III of this subchapter for the taxable year if (without regard to income not effectively connected with the conduct of any trade or business within the United States) it were a domestic corporation, such corporation shall be taxable under such part on its income effectively connected with its conduct of any trade or business within the United States. With respect to the remainder of its income, which is from sources within the

United States, such a foreign corporation shall be taxable as provided in section 881."

(2) The table of sections for part IV of subchapter L of chapter 1 is amended by striking out the item relating to section 842 and inserting in lieu thereof the following:

"Sec. 842. Foreign corporations carrying on insurance business."

(3) Section 819 (relating to foreign life insurance companies) is amended—

(A) by striking out subsections (a) and (d) and by redesignating subsections (b) and (c) as subsections (a) and (b),

(B) by striking out "In the case of any company described in subsection (a)," in subsection (a)(1) (as redesignated by subparagraph (A)) and inserting in lieu thereof "In the case of any foreign corporation taxable under this part,",

(C) by striking out "subsection (c)" in the last sentence of subsection (a)(2) (as redesignated by subparagraph (A)) and inserting in lieu thereof "subsection (b)",

(D) by adding at the end of subsection (a) (as redesignated by subparagraph (A)) the following new paragraph:

"(3) REDUCTION OF SECTION 881 TAX.—In the case of any foreign corporation taxable under this part, there shall be determined—

"(A) the amount which would be subject to tax under section 881 if the amount taxable under such section were determined without regard to sections 103 and 894, and

"(B) the amount of the reduction provided by paragraph (1).

The tax under section 881 (determined without regard to this paragraph) shall be reduced (but not below zero) by an amount which is the same proportion of such tax as the amount referred to in subparagraph (B) is of the amount referred to in subparagraph (A); but such reduction in tax shall not exceed the increase in tax under this part by reason of the reduction provided by paragraph (1).",

(E) by striking out "for purposes of subsection (a)" each place it appears in subsection (b) (as redesignated by subparagraph (A)) and inserting in lieu thereof "with respect to a foreign corporation",

(F) by striking out "foreign life insurance company" each place it appears in such subsection (b) and inserting in lieu thereof "foreign corporation",

(G) by striking out "subsection (b)(2)(A)" each place it appears in such subsection (b) and inserting in lieu thereof "subsection (a)(2)(A)",

(H) by striking out "subsection (b)(2)(B)" in paragraph (2)(B)(ii) of such subsection (b) and inserting in lieu thereof "subsection (a)(2)(B)", and

(I) by adding at the end thereof the following new subsection:

"(c) CROSS REFERENCE.—

"For taxation of foreign corporations carrying on life insurance business within the United States, see section 842."

(4) Section 821 (relating to tax on mutual insurance companies to which part II applies) is amended—

(A) by striking out subsection (e) and by redesignating subsections (f) and (g) as subsections (e) and (f), and

(B) by adding at the end of subsection (f) (as redesignated by subparagraph (A)) the following:

"(3) For taxation of foreign corporations carrying on an insurance business within the United States, see section 842."

(5) Section 822 (relating to determination of taxable investment income) is amended by striking out subsection (e) and by redesignating subsection (f) as subsection (e).

(6) Section 831 (relating to tax on certain other insurance companies) is amended—

(A) by striking out subsection (b) and by redesignating subsection (c) as subsection (b), and

(B) by amending subsection (d) to read as follows:

"CROSS REFERENCES.—

"(1) For alternative tax in case of capital gains, see section 1201(a).

"(2) For taxation of foreign corporations carrying on an insurance business within the United States, see section 842."

(7) Section 832 (relating to insurance company taxable income) is amended by striking out subsection (d) and by redesignating subsection (e) as subsection (d).

(8) The second sentence of section 841 (relating to credit for foreign taxes) is amended by striking out "sentence," and inserting in lieu thereof "sentence (and for purposes of applying section 906 with respect to a foreign corporation subject to tax under this subchapter),".

(h) SUBPART F INCOME.—Section 952(b) (relating to exclusion of United States income) is amended to read as follows:

"(b) EXCLUSION OF UNITED STATES INCOME.—In the case of a controlled foreign corporation, subpart F income does not include any item of income from sources within the United States which is effectively connected with the conduct by such corporation of a trade or business within the United States unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a treaty obligation of the United States."

(i) GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS.—Paragraph (4) of section 1248(d) (relating to exclusions from earnings and profits) is amended to read as follows:

"(4) UNITED STATES INCOME.—Any item includible in gross income of the foreign corporation under this chapter—

"(A) for any taxable year beginning before January 1, 1967, as income derived from sources within the United States of a foreign corporation engaged in trade or business within the United States, or

"(B) for any taxable year beginning after December 31, 1966, as income effectively connected with the conduct by such corporation of a trade or business within the United States.

This paragraph shall not apply with respect to any item which is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a treaty obligation of the United States."

(j) DECLARATION OF ESTIMATED INCOME TAX BY CORPORATIONS.—Section 6016 (relating to declarations of estimated income tax by corporations) is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) CERTAIN FOREIGN CORPORATIONS.—For purposes of this section and section 6655, in the case of a foreign corporation subject to taxation under section 11 or 1201(a), or under subchapter L of chapter 1, the tax imposed by section 881 shall be treated as a tax imposition by section 11."

(k) TECHNICAL AMENDMENTS.—

(1) Section 884 is amended to read as follows:

"SEC. 884. CROSS REFERENCES.

"(1) For special provisions relating to unrelated business income of foreign educational, charitable, and certain other exempt organizations, see section 512(a).

"(2) For special provisions relating to foreign corporations carrying on an insurance business within the United States, see section 842.

"(3) For rules applicable in determining whether any foreign corporation is engaged in trade or business within the United States, see section 864(b).

"(4) For reinstatement of pre-1967 income tax provisions in the case of corporations of certain foreign countries, see section 896.

"(5) For allowance of credit against the tax in case of a foreign corporation having income effectively connected with the conduct of a trade or business within the United States, see section 906.

"(6) For withholding at source of tax on income of foreign corporations, see section 1442."

(2) Section 953(b)(3)(F) is amended by striking out "832(b)(5)" and inserting in lieu thereof "832(c)(5)".

(3) Section 1249(a) is amended by striking out "Except as provided in subsection (c), gain" and inserting in lieu thereof "Gain".

(1) EFFECTIVE DATES.—The amendments made by this section (other than subsection (i)) shall apply with respect to taxable years beginning after December 31, 1966. The amendment made by subsection (i) shall apply with respect to sales or exchanges occurring after December 31, 1966.

SEC. 5. SPECIAL TAX PROVISIONS.

(a) INCOME AFFECTED BY TREATY.—Section 894 (relating to income exempt under treaties) is amended to read as follows:

"SEC. 894. INCOME AFFECTED BY TREATY.

"(a) INCOME EXEMPT UNDER TREATY.—Income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

"(b) PERMANENT ESTABLISHMENT IN UNITED STATES.—For purposes of applying any exemption from, or reduction of, any tax provided by any treaty to which the United States is a party with respect to income which is not effectively connected with the conduct of a trade or business within the United States, a nonresident alien individual or a foreign corporation shall be deemed not to have a permanent establishment in the United States at any time during the taxable year. This subsection shall not apply in respect of the tax computed under section 877(b)."

(b) APPLICATION OF PRE-1967 INCOME TAX PROVISIONS.—Subpart C of part II of subchapter N of chapter 1 (relating to miscellaneous provisions applicable to nonresident aliens and foreign corporations) is amended by adding at the end thereof the following new section:

"SEC. 896. APPLICATION OF PRE-1967 INCOME TAX PROVISIONS.

"(a) IMPOSITION OF MORE BURDENSOME TAXES BY FOREIGN COUNTRY.—Whenever the President finds that—

"(1) under the laws of any foreign country, considering the tax system of such foreign country, citizens of the the United States not residents of such foreign country or domestic corporations are being subjected to more burdensome taxes, on any item of income received by such citizens or corporations from sources within such foreign country, than taxes imposed by the provisions of this subtitle on similar income derived from sources within the United States by residents or corporations of such foreign country,

"(2) such foreign country, when requested by the United States to do so, has not acted to revise or reduce such taxes so that they are no more burdensome than taxes imposed by the provisions of this subtitle on similar income derived from sources within the United States by residents or corporations of such foreign country, and

"(3) it is in the public interest to apply pre-1967 tax provisions in accordance with the provisions of this section to residents or corporations of such foreign country,

the President shall proclaim that the tax on such similar income derived from sources within the United States by residents or corporations of such foreign country shall, for taxable years beginning after such proclamation, be determined under this subtitle without regard to amendments made to this subchapter and chapter 3 on or after the date of enactment of this section.

"(b) ALLEVIATION OF MORE BURDENSOME TAXES.—Whenever the President finds that the laws of any foreign country with respect to which the President has made a proclamation under subsection (a) have been modified so that citizens of the United States not residents of such foreign country or domestic corporations are no longer subject to more burdensome taxes on such item of income derived by such citizens or corporations from sources within such foreign country, he shall proclaim that the tax on such similar income derived from sources within the United States by residents or corporations of such foreign country shall, for any taxable year beginning after such proclamation, be determined under this subtitle without regard to subsection (a).

"(c) NOTIFICATION OF CONGRESS REQUIRED.—No proclamation shall be issued by the President pursuant to this section unless, at least 30 days prior to such proclamation, he has notified the Senate and the House of Representatives of his intention to issue such proclamation.

"(d) IMPLEMENTATION BY REGULATIONS.—The Secretary or his delegate shall prescribe such regulations as he deems necessary or appropriate to implement this section."

(c) CLERICAL AMENDMENTS.—The table of sections for subpart C of part II of subchapter N of chapter 1 is amended—

(1) by striking out the item relating to section 894 and inserting in lieu thereof

"Sec. 894. Income affected by treaty.";

(2) by adding at the end of such table the following:

"Sec. 896. Application of pre-1967 income tax provisions."

(d) EFFECTIVE DATE.—The amendments made by this section (other than subsection (e)) shall apply with respect to taxable years beginning after December 31, 1966.

(e) ELECTIONS BY NONRESIDENT UNITED STATES CITIZENS WHO ARE SUBJECT TO FOREIGN COMMUNITY PROPERTY LAWS.—

(1) 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 H—Income of Certain Nonresident United States Citizens Subject to Foreign Community Property Laws

"Sec. 981. Elections as to treatment of income subject to foreign community property laws.

"SEC. 981. ELECTION AS TO TREATMENT OF INCOME SUBJECT TO FOREIGN COMMUNITY PROPERTY LAWS.

"(a) GENERAL RULE.—In the case of any taxable year beginning after December 31, 1966, if—

"(1) an individual is (A) a citizen of the United States, (B) a bona fide resident of a foreign country or countries during the entire taxable year, and (C) married at the close of the taxable year to a spouse who is a nonresident alien during the entire taxable year, and

"(2) such individual and his spouse elect to have subsection (b) apply to their community income under foreign community property laws,

then subsection (b) shall apply to such income of such individual and such spouse for the taxable year and for all subsequent taxable years for which the requirements of paragraph (1) are met, unless the Secretary or his delegate consents to a termination of the election.

"(b) TREATMENT OF COMMUNITY INCOME.—For any taxable year to which an election made under subsection (a) applies, the community income under foreign community property laws of the husband and wife making the election shall be treated as follows:

"(1) Earned income (within the meaning of the first sentence of section 911(b)), other than trade or business income and a partner's distributive share of partnership income, shall be treated as the income of the spouse who rendered the personal services.

"(2) Trade or business income, and a partner's distributive share of partnership income, shall be treated as provided in section 1402(a) (5).

"(3) Community income not described in paragraph (1) or (2) which is derived from the separate property (as determined under the applicable foreign community property law) of one spouse shall be treated as the income of such spouse.

"(4) All other such community income shall be treated as provided in the applicable foreign community property law.

"(c) ELECTION FOR PRE-1967 YEARS.—

"(1) ELECTION.—If an individual meets the requirements of subsection (a)(1) (A) and (C) for any taxable year beginning before January 1, 1967, and if such individual and the spouse referred to in subsection (a)(1)(C) elect under this subsection, then paragraph (2) of this subsection shall apply to their community income under foreign community property laws for all open taxable years beginning before January 1, 1967 (whether under this chapter, the corresponding provisions of the Internal Revenue Code of 1939, or the corresponding provisions of prior revenue laws), for which the requirements of subsection (a)(1) (A) and (C) are met.

"(2) EFFECT OF ELECTION.—For any taxable year to which an election made under this subsection applies, the community income under foreign community property laws of the husband and wife making the election shall be treated as provided by subsection (b), except that the other community income described in paragraph (4) of subsection (b) shall be treated as the income of the spouse who, for such taxable year, had gross income under paragraphs (1), (2), and (3) of subsection (b), plus separate gross income, greater than that of the other spouse.

"(d) TIME FOR MAKING ELECTIONS; PERIOD OF LIMITATIONS; ETC.—

"(1) TIME.—An election under subsection (a) or (c) for a taxable year may be made at any time while such year is still open, and shall be made in such manner as the Secretary or his delegate shall by regulations prescribe.

"(2) EXTENSION OF PERIOD FOR ASSESSING DEFICIENCIES AND MAKING REFUNDS.—If any taxable year to which an election under subsection (a) or (c) applies is open at the time such election is made, the period for assessing a deficiency against, and the period for filing claim for credit or refund of any overpayment by, the husband and wife for such taxable year, to the extent such deficiency or overpayment is attributable to such an election, shall not expire before 1 year after the date of such election.

"(3) ALIEN SPOUSE NEED NOT JOIN IN SUBSECTION (C) ELECTION IN CERTAIN CASES.—If the Secretary or his delegate determines—

"(A) that an election under subsection (c) would not affect the liability for Federal income tax of the spouse referred to in subsection (a)(1) (C) for any taxable year, or

"(B) that the effect on such liability for tax cannot be ascertained and that to deny the election to the citizen of the United Sates would be inequitable and cause undue hardship.

such spouse shall not be required to join in such election, and paragraph (2) of this subsection shall not apply with respect to such spouse.

"(4) INTEREST.—To the extent that any overpayment or deficiency for a taxable year is attributable to an election made under this section, no interest shall be allowed or paid for any period before the day which is 1 year after the date of such election.

"(e) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) DEDUCTIONS.—Deductions shall be treated in a manner consistent with the manner provided by this section for the income to which they relate.

"(2) OPEN YEARS.—A taxable year of a citizen of the United States and his spouse shall be treated as 'open' if the period for assessing a deficiency against such citizen for such year has not expired before the date of the election under subsection (a) or (c), as the case may be.

"(3) ELECTIONS IN CASE OF DECEDENTS.—If a husband or wife is deceased his election under this section may be made by his executor, administrator, or other person charged with his property.

"(4) DEATH OF SPOUSE DURING TAXABLE YEAR.—In applying subsection (a)(1)(C), and in determining under subsection (c)(2) which spouse has the greater income for a taxable year, if a husband or wife dies the taxable year of the surviving spouse shall be treated as ending on the date of such death."

(2) The table of subparts for such part III is amended by adding at the end thereof the following:

Subpart H. Income of certain nonresident United States citizens subject to foreign community property laws."

(3) Section 911(d) (relating to earned income from sources without the United States) is amended—

(A) by striking out "For administrative" and inserting in lieu thereof the following: "(1) For administrative"; and

(B) by adding at the end thereof the following:

"(2) For elections as to treatment of income subject to foreign community property laws, see section 981."

SEC. 6. FOREIGN TAX CREDIT.

(a) ALLOWANCE OF CREDIT TO CERTAIN NONRESIDENT ALIENS AND FOREIGN CORPORATIONS.—

(1) Subpart A of part III of subchapter N of chapter 1 (relating to foreign tax credit) is amended by adding at the end thereof the following new section:

"SEC. 906. NONRESIDENT ALIEN INDIVIDUALS AND FOREIGN CORPORATIONS.

"(a) ALLOWANCE OF CREDIT.—A nonresident alien individual or a foreign corporation engaged in trade or business within the United States during the taxable year shall be allowed a credit under section 901 for the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year (or deemed, under section 902, paid or accrued during the taxable year) to any foreign country or possession of the United States with respect to income effectively connected with the conduct of a trade or business within the United States.

"(b) SPECIAL RULES.—

"(1) For purposes of subsection (a) and for purposes of determining the deductions allowable under sections 873(a) and 882(c), in determining the amount of any tax paid or accrued to any foreign country or possession there shall not be taken into account any amount of tax to the extent the tax so paid or accrued is imposed with respect to income which would not be taxed by such foreign country or possession but for the fact that—

"(A) in the case of a nonresidential alien individual, such individual is a citizen or resident of such foreign country or possession, or

"(B) in the case of a foreign corporation, such corporation was created or organized under the law of such foreign country or possession or is domiciled for tax purposes in such country or possession.

"(2) For purposes of subsection (a), in applying section 904 the taxpayer's taxable income shall be treated as consisting only of the taxable income effectively connected with the taxpayer's conduct of a trade or business within the United States.

"(3) The credit allowed pursuant to subsection (a) shall not be allowed against any tax imposed by section 871(a) (relating to income of nonresident alien individual not connected with United States business) or 881 (relating to income of foreign corporations not connected with United States business).

"(4) For purposes of sections 902(a) and 78, a foreign corporation choosing the benefits of this subpart which receives dividends shall, with respect to such dividends, be treated as a domestic corporation."

(2) The table of sections for such subpart A is amended by adding at the end thereof the following:

"Sec. 906. Nonresident alien individuals and foreign corporations."

(3) Section 874(c) is amended by striking out

"(c) FOREIGN TAX CREDIT NOT ALLOWED.—A nonresident" and inserting in lieu thereof the following:

"(c) FOREIGN TAX CREDIT.—Except as provided in section 906, a nonresident".

(4) Subsection (b) of section 901 (relating to amount allowed) is amended by redesignating paragraph (4) as paragraph (5), and by inserting after paragraph (3) the following new paragraph:

"(4) NONRESIDENT ALIEN INDIVIDUALS AND FOREIGN CORPORATIONS.—In the case of any nonresident alien individual not described in section 876 and in the case of any foreign corporation, the amount determined pursuant to section 906; and".

(5) Paragraph (5) (as redesignated) of section 901(b) is amended by striking out "or (3)," and inserting in lieu thereof "(3), or (4),".

(6) The amendments made by this subsection shall apply with respect to taxable years beginning after December 31, 1966. In applying section 904 of the Internal Revenue Code of 1954 with respect to section 906 of such Code, no amount may be carried from or to any taxable year beginning before January 1, 1967, and no such year shall be taken into account.

(b) ALIEN RESIDENTS OF THE UNITED STATES OR PUERTO RICO.—

(1) Paragraph (3) of section 901(b) (relating to amount of foreign tax credit allowed in case of alien resident of the United States or Puerto Rico) is amended by striking out ", if the foreign country of which such alien

resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country".

(2) Section 901 is amended by redesignating subsections (c) and (d) as subsections (d) and (e), and by inserting after subsection (b) the following new subsection:

"(c) SIMILAR CREDIT REQUIRED FOR CERTAIN ALIEN RESIDENTS.—Whenever the President finds that—

"(1) a foreign country, in imposing income, war profits, and excess profits taxes, does not allow to citizens of the United States residing in such foreign country a credit for any such taxes paid or accrued to the United States or any foreign country, as the case may be, similar to the credit allowed under subsection (b)(3),

"(2) such foreign country, when requested by the United States to do so, has not acted to provide such a similar credit to citizens of the United States residing in such foreign country, and

"(3) it is in the public interest to allow the credit under subsection (b)(3) to citizens or subjects of such foreign country only if it allows such a similar credit to citizens of the United States residing in such foreign country,

the President shall proclaim that, for taxable years beginning while the proclamation remains in effect, the credit under subsection (b)(3) shall be allowed to citizens or subjects of such foreign country only if such foreign country, in imposing income, war profits, and excess profits taxes, allows to citizens of the United States residing in such foreign country such a similar credit."

(3) Section 2014 (relating to credit for foreign death taxes) is amended by striking out the second sentence of subsection (a), and by adding at the end of such section the following new subsection:

"(h) SIMILAR CREDIT REQUIRED FOR CERTAIN ALIEN RESIDENTS.—Whenever the President finds that—

"(1) a foreign country, in imposing estate, inheritance, legacy, or succession taxes, does not allow to citizens of the United States resident in such foreign country at the time of death a credit similar to the credit allowed under subsection (a),

"(2) such foreign country, when requested by the United States to do so, has not acted to provide such a similar credit in the case of citizens of the United States resident in such foreign country at the time of death, and

"(3) it is in the public interest to allow the credit under subsection (a) in the case of citizens or subjects of such foreign country only if it allows such a similar credit in the case of citizens of the United States resident in such foreign country at the time of death,

the President shall proclaim that, in the case of citizens or subjects of such foreign country dying while the proclamation remains in effect, the credit under subsection (a) shall be allowed only if such foreign country allows such a similar credit in the case of citizens of the United States resident in such foreign country at the time of death."

(4) The amendments made by this subsection (other than paragraph (3)) shall apply with respect to taxable years beginning after December 31, 1966. The amendment made by paragraph (3) shall apply with respect to estates of decedents dying after the date of the enactment of this Act.

(c) FOREIGN TAX CREDIT IN CASE OF CERTAIN OVERSEAS OPERATIONS FUNDING SUBSIDIARIES.—

(1) Section 904(f)(2) (relating to application of limitations on foreign tax credit in case of certain interest income) is amended—

(A) by striking out "or" at the end of subparagraph (C),

(B) by striking out the period at the end of subparagraph (D) and inserting in lieu thereof ", or", and

(C) by adding at the end thereof the following new subparagraph:

"(E) received by an overseas operations funding subsidiary on obligations of a related foreign corporation."

(2) Section 904(f) is amended by adding at the end thereof the following new paragraph:

"(5) DEFINITIONS FOR PURPOSES OF PARAGRAPH (1)(E).—For purposes of paragraph (1)(E).—

"(A) the term 'overseas operations funding subsidiary' means a domestic corporation which (i) is a member of an affiliated group (within the meaning of section 1504) and is not the common parent corporation, and (ii) was formed and is availed of for the principal purpose of raising funds outside the United States through public offerings to foreign persons and of using such funds to finance the operationss in foreign countries of one or more related foreign corporations, and

"(B) a foreign corporation is, with respect to an overseas operations funding subsidiary, a related foreign corporation if the affiliated group of which such subsidiary is a member owns 50 percent or more of the voting stock of such foreign corporation either directly or through ownership of the voting stock of another foreign corporation."

(3) The amendments made by paragraphs (1) and (2) shall apply to interest received after December 31, 1965, in taxable years ending after such date.

SEC. 7. AMENDMENT TO PRESERVE EXISTING LAW ON DEDUCTIONS UNDER SECTION 931.

(a) DEDUCTIONS.—Subsection (d) of section 931 (relating to deductions) is amended to read as follows:

"(d) DEDUCTIONS.—

"(1) GENERAL RULE.—Except as otherwise provided in this subsection and subsection (e), in the case of persons entitled to the benefits of this section the deductions shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined as provided in part I, under regulations prescribed by the Secretary or his delegate.

"(2) EXCEPTIONS.—The following deductions shall be allowed whether or not they are connected with income from sources within the United States:

"(A) The deduction, for losses not connected with the trade or business if incurred in transactions entered into for profit, allowed by section 165(c)(2), but only if the profit, if such transaction had resulted in a profit, would be taxable under this subtitle.

"(B) The deduction, for losses of property not connected with the trade or business if arising from certain casualties or theft, allowed by sections 165(c)(3), but only if the loss is of property with the United States.

"(C) The deduction for charitable contributions and gifts allowed by section 170.

"(3) DEDUCTION DISALLOWED.—

"For disallowance of standard deduction, see section 142(b)(2)."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply with respect to taxable years beginning after December 31, 1966.

SEC. 8. ESTATES OF NONRESIDENTS NOT CITIZENS.

(a) RATE OF TAX.—Subsection (a) of section 2101 (relating to tax imposed in case of estates of nonresidents not citizens) is amended to read as follows:

"(a) RATE OF TAX.—Except as provided in section 2107, a tax computed in accordance with the following table is hereby imposed on the transfer of the taxable estate, determined as provided in section 2106, of every decedent nonresident not a citizen of the United States:

"If the taxable estate is:	The tax shall be:
Not over $100,000	5% of the taxable estate.
Over $100,000 but not over $500,000	$5,000, plus 10% of excess over $100,000.
Over $500,000 but not over $1,000,000	$45,000, plus 15% of excess over $500,000.
Over $1,000,000 but not over $2,000,000	$120,000, plus 20% of excess over $1,000,000.
Over $2,000,000	$320,000, plus 25% of excess over $2,000,000."

(b) CREDITS AGAINST TAX.—Section 2102 (relating to credits allowed against estate tax) is amended to read as follows:

"SEC. 2102. CREDITS AGAINST TAX.

"(a) IN GENERAL.—The tax imposed by section 2101 shall be credited with the amounts determined in accordance with sections 2011 to 2013, inclusive (relating to State death taxes, gift tax, and tax on prior transfers), subject to the special limitation provided in subsection (b).

"(b) SPECIAL LIMITATION.—The maximum credit allowed under section 2011 against the tax imposed by section 2101 for State death taxes paid shall be an amount which bears the same ratio to the credit computed as provided in section

2011(b) as the value of the property, as determined for purposes of this chapter, upon which State death taxes were paid and which is included in the gross estate under section 2103 bears to the value of the total gross estate under section 2103. For purposes of this subsection, the term 'State death taxes' means the taxes described in section 2011(a)."

(c) PROPERTY WITHIN THE UNITED STATES.—Section 2104 (relating to property within the United States) is amended by adding at the end thereof the following new subsection:

"(c) DEBT OBLIGATIONS.—For purposes of this subchapter, debt obligations of—

"(1) a United States person, or

"(2) the United States, a State or any political subdivision thereof, or the District of Columbia,

owned by a nonresident not a citizen of the United States shall be deemed property within the United States. This subsection shall not apply to a debt obligation of a domestic corporation if any interest on such obligation, were such interest received by the decedent at the time of his death, would be treated by reason of section 861(a)(1)(B) as income from sources without the United States."

(d) PROPERTY WITHOUT THE UNITED STATES.—Subsection (b) of section 2105 (relating to bank deposits) is amended to read as follows:

"(b) DEPOSITS IN CERTAIN FOREIGN BRANCHES.—For purposes of this subchapter, deposits with a foreign branch of a domestic corporation, if such branch is engaged in the commercial banking business, shall not be deemed property within the United States."

(e) DEFINITION OF TAXABLE ESTATE.—Paragraph (3) of section 2106(a) (relating to deduction of exemption from gross estate) is amended to read as follows:

"(3) EXEMPTION.—

"(A) GENERAL RULE.—An exemption of $30,000.

"(B) RESIDENTS OF POSSESSIONS OF THE UNITED STATES.—In the case of a decedent who is considered to be a 'nonresident not a citizen of the United States' under the provisions of section 2209, the exemption shall be the greater of (i) $30,000, or (ii) that proportion of the exemption authorized by section 2052 which the value of that part of the decedent's gross estate which at the time of his death is situated in the United States bears to the value of his entire gross estate wherever situated."

(f) SPECIAL METHODS OF COMPUTING TAX.—Subchapter B of chapter 11 (relating to estates of nonresidents not citizens) is amended by adding at the end thereof the following new sections:

"SEC. 2107. EXPATRIATION TO AVOID TAX.

"(a) RATE OF TAX.—A tax computed in accordance with the table contained in section 2001 is hereby imposed on the transfer of the taxable estate, determined as provided in section 2106, of every decedent nonresident not a citizen of the United States dying after the date of enactment of this section, if after March 8, 1965, and wihin the 10-year period ending with the date of death such decedent lost United States citizenship, unless such loss did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle A.

"(b) GROSS ESTATE.—For purposes of the tax imposed by subsection (a), the value of the gross estate of every decedent to whom subsection (a) applies shall be determined as provided in section 2103, except that—

"(1) if such decedent owned (within the meaning of section 958(a)) at the time of his death 10 percent or more of the total combined voting power of all classes of stock entitled to vote of a foreign corporation, and

"(2) if such decedent owned (within the meaning of section 958(a)), or is considered to have owned (by applying the ownership rules of section 958 (b)), at the time of his death, more than 50 percent of the total combined voting power of all classes of stock entitled to vote of such foreign corporation,

then that proportion of the fair market value of the stock of such foreign corporation owned (within the meaning of section 958(a)) by such decedent at the time of his death, which the fair market value of any assets owned by such foreign corporation and situated in the United States, at the time of his death, bears to the total fair market value of all assets owned by such foreign corporation at the time of his death, shall be included in the gross estate of such decedent.

For purposes of the preceding sentence, a decedent shall be treated as owning stock of a foreign corporation at the time of his death, if, at the time of a transfer, by trust or otherwise, within the meaning of sections 2035 to 2038, inclusive, he owned such stock.

"(c) CREDITS.—The tax imposed by subsection (a) shall be credited with the amounts determined in accordance with section 2102.

"(d) EXCEPTION FOR LOSS OF CITIZENSHIP FOR CERTAIN CAUSES.—Subsection (a) shall not apply to the transfer of the estate of a decedent whose loss of United States citizenship resulted from the application of section 301(b), 350, or 355 of the Immigration and Nationality Act, as amended (8 U.S.C. 1401(b) 1482, or 1487).

"(e) BURDEN OF PROOF.—If the Secretary or his delegate establishes that it is reasonable to believe that an individual's loss of United States citizenship would, but for this section, result in a substantial reduction in the estate, inheritance, legacy, and succession taxes in respect of the transfer of his estate, the burden of proving that such loss of citizenship did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle A shall be on the executor of such individual's estate.

"SEC. 2108. APPLICATION OF PRE-1967 ESTATE TAX PROVISIONS.

"(a) IMPOSITION OF MORE BURDENSOME TAX BY FOREIGN COUNTRY.—Whenever the President finds that—

"(1) under the laws of any foreign country, considering the tax system of such foreign country, a more burdensome tax is imposed by such foreign country on the transfer of estates of decedents who were citizens of the United States and not residents of such foreign country than the tax imposed by this subchapter on the transfer of estates of decedents who were residents of such foreign country,

"(2) such foreign country, when requested by the United States to do so, has not acted to revise or reduce such tax so that it is no more burdensome than the tax imposed by this subchapter on the transfer of estates of decedents who were residents of such foreign country, and

"(3) it is in the public interest to apply pre-1967 tax provisions in accordance with this section to the transfer of estates of decedents who were residents of such foreign country,

the President shall proclaim that the tax on the transfer of the estate of every decedent who was a resident of such foreign country at the time of his death shall, in the case of decedents dying after the date of such proclamation, be determined under this subchapter without regard to amendments made to sections 2101 (relating to tax imposed), 2102 (relating to credits against tax), 2106 (relating to taxable estate), and 6018 (relating to estate tax returns) on or after the date of enactment of this section.

"(b) ALLEVIATION OF MORE BURDENSOME TAX.—Whenever the President finds that the laws of any foreign country with respect to which the President has made a proclamation under subsection (a) have been modified so that the tax on the transfer of estates of decedents who were citizens of the United States and not residents of such foreign country is no longer more burdensome than the tax imposed by this subchapter on the transfer of estates of decedents who were residents of such foreign country, he shall proclaim that the tax on the transfer of the estate of every decedent who was a resident of such foreign country at the time of his death shall, in the case of decedents dying after the date of such proclamation, be determined under this subchapter without regard to subsection (a).

"(c) NOTIFICATION OF CONGRESS REQUIRED.—No proclamation shall be issued by the President pursuant to this section unless, at least 30 days prior to such proclamation, he has notified the Senate and the House of Representatives of his intention to issue such proclamation.

"(d) IMPLEMENTATION BY REGULATIONS.—The Secretary or his delegate shall prescribe such regulations as may be necessary or appropriate to implement this section."

(g) ESTATE TAX RETURNS.—Paragraph (2) of section 6018(a) (relating to estate of nonresidents not citizens) is amended by striking out "$2,000" and inserting in lieu thereof "$30,000".

(h) CLERICAL AMENDMENT.—The table of sections for subchapter B of chapter 11 (relating to estates of nonresidents not citizens) is amended by adding at the end thereof the following:

"Sec. 2107. Expatriation to avoid tax.
"Sec. 2108. Application of pre-1967 estate tax provisions."

(i) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to estates of decedents dying after the date of the enactment of this Act.

SEC. 9. TAX ON GIFTS OF NONRESIDENTS NOT CITIZENS.

(a) IMPOSITION OF TAX.—Subsection (a) of section 2501 (relating to general rule for imposition of tax) is amended to read as follows:

"(a) TAXABLE TRANSFERS.—

"(1) GENERAL RULE.—For the calendar year 1955 and each calendar year thereafter a tax, computed as provided in section 2502, is hereby imposed on the transfer of property by gift during such calendar year by any individual, resident or nonresident.

"(2) TRANSFERS OF INTANGIBLE PROPERTY.—Except as provided in paragraph (3), paragraph (1) shall not apply to the transfer of intangible property by a nonresident not a citizen of the United States.

"(3) EXCEPTIONS.—Paragraph (2) shall not apply in the case of a donor who at any time after March 8, 1965, and within the 10-year period ending with the date of transfer lost United States citizenship unless—

"(A) such donor's loss of United States citizenship resulted from the application of section 301(b), 350, or 355 of the Immigration and Nationality Act, as amended (8 U.S.C. 1401(b), 1482, or 1487), or

"(B) such loss did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle A.

"(4) BURDEN OF PROOF.—If the Secretary or his delegate establishes that it is reasonable to believe that an individual's loss of United States citizenship would, but for paragraph (3), result in a substantial reduction for the calendar year in the taxes on the transfer of property by gift, the burden of proving that such loss of citizenship did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle A shall be on such individual."

(b) TRANSFER IN GENERAL.—Subsection (b) of section 2511 (relating to situs rule for stock in a corporation) is amended to read as follows:

"(b) INTANGIBLE PROPERTY.—For the purposes of this chapter, in the case of a nonresident not a citizen of the United States who is excepted from the application of section 2501(a)(2)—

"(1) shares of stock issued by a domestic corporation, and

"(2) debt obligations of—

"(A) a United States persons, or

"(B) the United States, a State or any political subdivision thereof, or the District of Columbia,

which are owned by such nonresidents shall be deemed to be property situated within the United States."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to the calendar year 1967 and all calendar years thereafter.

SEC. 10. TREATY OBLIGATIONS.

No amendment made by this Act shall apply in any case where its application would be contrary to any treaty obligation of the United States. For purposes of the preceding sentence, the extension of a benefit provided by any amendment made by this Act shall not be deemed to be contrary to a treaty obligation of the United States.

Passed the House of Representatives June 15, 1966.

Attest: RALPH R. ROBERTS,
Clerk.

(Departmental comments on H.R. 13103 follow:)

EXECUTIVE OFFICE OF THE PRESIDENT,
BUREAU OF THE BUDGET,
Washington, D.C., August 10, 1966.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance, U.S. Senate,
New Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your request for the views of the Bureau of the Budget on H.R. 13103, an act "To amend the Internal Revenue Code of 1954 to provide equitable tax treatment for foreign investment in the United States," and on an amendment intended to be proposed by Mr. Dirksen to H.R. 13103.

H.R. 13103 is a modified version of H.R. 5916, a bill introduced in March 1965, to carry out recommendations of the Treasury Department. H.R. 5916 was a part of the President's program to improve the United States balance of payments.

We believe that H.R. 13103, by providing more equitable tax treatment for foreign investors, will tend to enhance the attractiveness of investment in the United States and thereby have a favorable effect on our balance of payments. Accordingly, the Bureau of the Budget recommends enactment of the bill.

The proposed amendment to H.R. 13103 would give the President discretionary authority to impose or remove the interest equalization tax on dollar loans made by foreign branches of U.S. banks. We have no objection to this amendment.

Sincerely yours,

WILFRED H. ROMMEL,
Assistant Director for Legislative Reference.

GENERAL COUNSEL OF THE DEPARTMENT OF COMMERCE,
Washington, D.C., August 18, 1966.

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

DEAR MR. CHAIRMAN: This is in further reply to your request for the views of this Department concerning H.R. 13103, an act to amend the Internal Revenue Code of 1954 to provide equitable tax treatment for foreign investment in the United States.

The act as passed by the House would reduce U.S. tax upon the estates of nonresident aliens, thereby providing more equitable tax treatment in line with that applied to estates of U.S. citizens. The bill would also limit U.S. tax on nonresident aliens' investment income while taxing their trade and business income in the same manner that a U.S. citizen's trade and business income is taxed.

The estate tax applied to estates of aliens domiciled abroad would be reduced considerably by increasing the current $2,000 exemption to $30,000 and by reflecting the new alien estate tax rate schedule a marital deduction of 50 percent of the taxable estate, which deduction currently is not allowed. The present high estate tax on nonresident aliens discourages many of them from investing in the United States. This reduction will make the United States more attractive as a place to invest one's savings and should increase foreign investment here.

The act extends the income tax exemption presently given interest paid on bank deposits to nonresident aliens not engaged in trade or business in the United States to interest and dividends paid on share deposits by savings and loan associations and interest paid by insurance companies. However, beginning in 1972 all such payments would become subject to tax on U.S. source income.

The act would restructure the income tax treatment accorded nonresident aliens and foreign corporations so as to tax their investment income at the flat rate of 30 percent or the lower treaty rate, and to tax their income effectively connected with the carrying on of a U.S. trade or business at the regular income tax rates applied to resident individuals and domestic corporations. Currently nonresident aliens not engaged in trade or business in the United States are taxed at either the 30-percent rate or higher graduated rates, whichever produces more tax, except that if a rate has been fixed by treaty, that rate will apply. Nonresident aliens and foreign corporations engaged in trade or business are taxed at the graduated rates on the net amount of all their U.S. source income.

On the one hand this change would make investment in the United States more attractive to foreign investors not residents of tax treaty countries, since it limits the tax rate to 30 percent. Also, any foreign investor in the higher tax brackets engaged in trade or business here would benefit so far as his U.S. investment income is concerned since under present law this is taxed at the graduated rates regardless of whether a tax treaty is in effect.

On the other hand the change would close the loophole allowed to foreign corporations that in reality are not engaged in business in the United States, but through a minimal amount of activity qualify for the 85-percent dividend deduction accorded to foreign corporations engaged in business. This results in an effective tax rate of less than 7½ percent as opposed to a 15-percent treaty rate or 30-percent rate that would apply under this bill. At the same time, those foreign corporations carrying on substantial business activities would be similarly affected. At the end of 1964 foreigners held stocks in U.S. corporations valued at about $13.8 billion as portfolio investments. No data are available on the percentage of these holdings owned by foreign corporations. Approximately 90 percent of the foreign investments in the United States are held by Western European and Canadian corporations or individuals. Most of these countries have income tax treaties with the United States limiting tax on U.S. source dividends to 15 percent. It is difficult to tell whether foreign corporations would change their investment policy because of the additional 7½ cents tax on each dollar of dividend. However, where the foreign taxing authority's rate exceeds 15 percent and the U.S. source income is subject to the foreign tax there would be no reason for foreign withdrawal of investment in U.S. stocks, because this change would merely reallocate between taxing authorities the same total amount of tax. Nor would there be any change in investment policy of Swiss banks holding stock as nominees since they are now paying the treaty rate on 30-percent rate where applicable.

As for the nonresident alien individual deriving more than $10,600 annual taxable income from trade or business in the United States, he would pay less tax on that portion of his income derived from investment. However, individuals doing business in the United States with total U.S. income of less than $10,000, including investment income, would pay somewhat more because the 30-percent tax on investment income would be higher than the applicable graduated rate. There are not many nonresident aliens not engaged in business in the United States paying the high graduated rate of tax. Elimination of the graduated rate of tax on investment income should therefore attract considerably more investment on the part of these individuals. The U.S. source capital gains of a nonresident alien not engaged in trade or business in the United States are to be taxed under the bill only if the alien was in the United States for 183 days or more during the year.

Currently nonresident aliens engaged in trade or business in the United States, those not engaged in trade or business but present in the United States 90 days or more, and those present less than 90 days but present at the time of sale, are taxable on their capital gains. The 183-day provision will be a strong inducement for nonresident aliens to invest in stocks and bonds of U.S. companies, particularly since the bill also permits investors to grant U.S. agents the discretionary authority to buy and sell their holdings without thereby being considered as having engaged in trade or business in the United States; being engaged in trade or business in the United States would subject the capital gains to U.S. income tax.

The bill would also give real estate investors an election to be treated as being engaged in trade or business so as to be taxed on net income rather than on gross income as is generally the case now. Currently a real estate investor can deduct interest, taxes, depreciation, etc., from his gross income in determining his taxable income only if he renders services to his tenants.

These tax relief measures would considerably increase the effective rate of return on investments in the United States and therefore should attract additional foreign investment here.

The bill would introduce into law the concept of taxing a foreign corporation on worldwide income of the corporation effectively connected with carrying on the activity of the U.S. branch. This concept would be limited to income attributable to an office in the United States conducting (1) licensing operations in the United States deriving income from the use of their licenses outside the United States; (2) banking or financing operations and some investment operations; or (3) branches in the United States deriving income from the sale of goods except where a branch outside the United States materially participated in the sale of the product for use outside the United States.

This taxing concept is equitable in that it would place the foreign corporation that is essentially a domestic corporation but for having been created in a foreign country, in the same tax position as its U.S. competitor. This change would also prevent foreigners from using the United States as a tax haven. U.S. exports would probably not be affected by this provision.

There apparently is a typographical error on page 69, line 4, in making reference to paragraph (1)(e). The reference should be to paragraph (2)(e) which contains the expression "overseas operations funding subsidiary" that is being defined.

We understand that objections have been raised that two provisions of H.R. 13103 may have some adverse effect upon the balance of payments or U.S. gold holdings. One of these provisions is the amendment making interest received by foreign investors on bank deposits in the United States subject to income tax after 1972. However, this provision would appear to have little immediate impact in view of the 1972 effective date. The other provision would subject to U.S. estate tax, U.S. bank deposits of deceased foreign investors. This provision would go into effect immediately upon enactment. It is difficult to determine the impact of this provision in view of the increased exemption and reduced rates provided in the bill for estates of foreign investors.

Subject to your consideration of the possible adverse effect of the two bank deposit provisions on the balance of payments and U.S. gold holdings, this Department is of the view that the subject bill would attract foreign investment to the United States. The Department of Commerce therefore recommends enactment of H.R. 13103.

We have been advised by the Bureau of the Budget that there would be no objection to the submission of our report to the Congress from the standpoint of the administration's program.

Sincerely,

ROBERT E. GILES, *General Counsel.*

DEPARTMENT OF STATE,
August 8, 1966.

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

DEAR MR. CHAIRMAN: This report on H.R. 13103, a bill "to amend the Internal Revenue Code of 1954 to provide equitable tax treatment for foreign investors in the United States," is submitted in response to your letter of June 17, 1966. H.R. 13103 would substantially implement the 1964 proposals of the Presidential task force on "Promoting Increased Foreign Investment in U.S. Corporate Securities and Increased Foreign Financing for U.S. Corporations Operating Abroad."

The Department of State believes that H.R. 13103, if enacted, would have a salutary effect on the U.S. balance of payments. By reducing certain existing tax disincentives to investment in United States assets, the bill would tend to enhance their attractiveness to foreigners. Especially noteworthy in this regard are the provisions in the bill dealing with estate tax rates, exemptions and returns; with the application of a separate tax rate for U.S. source income derived from royalties and investments in U.S. corporate securities as against source income "effectively connected" with the conduct of a United States trade or business; and with the uniform flat rate on fixed or determinable income of nonresident alien individuals.

The Department of State supports the objectives of H.R. 13103 and regards the proposed amendment to the Internal Revenue Code as reasonable and practicable steps for the accomplishment of those objectives. The Department regards Section 10 of the bill, which provides that no amendment is to be applied in contravention of any treaty obligation of the United States, as an essential part of the proposed legislation.

The Bureau of the Budget advises that from the standpoint of the Administration's program there is no objection to the submission of this report.

Sincerely yours,

DOUGLAS MACARTHUR II,
Assistant Secretary for Congressional Relations
(For the Secretary of State).

The CHAIRMAN. We are particularly happy to welcome as the first witness the Secretary of the Treasury, Hon. Henry H. Fowler. It was Mr. Fowler, before he became Secretary of the Treasury, who was asked by President Kennedy to serve as chairman of the task force and it was because of his strong and knowledgeable leadership that the 13-man group has come to be known universally as the Fowler task force.

Mr. Secretary, we are glad to have you. We hope we can expedite your appearance here today. And we ask the other witnesses who will follow you to observe the 15-minute limitation on oral testimony.

We do not propose to hold you to that limitation.

STATEMENT OF HON. HENRY H. FOWLER, SECRETARY OF THE TREASURY; ACCOMPANIED BY STANLEY S. SURREY, ASSISTANT SECRETARY FOR TAX POLICY; AND WINTHROP KNOWLTON, ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY

Secretary FOWLER. Thank you.

Mr. Chairman and members of the committee, I am appearing before you to urge prompt and favorable action on H.R. 13103, legislation which is intended to establish equitable tax treatment for foreign investment in the United States. Passage of this bill will serve an important national objective by providing a comprehensive and integrated revision of our present system of taxing foreign individuals and foreign corporations on income derived from the United States. The revision is supportable on tax policy criteria and brings our system of taxing foreigners more into line with the rules existing generally in the other developed countries of the world. A fundamental and enduring consequence of this revision will be increased interest on the part of foreigners generally in investment in the United States. This proposed legislation, therefore, is one of the important positive elements of our long-range balance-of-payments effort.

BACKGROUND OF PROPOSALS

In his balance-of-payments message of July 18, 1963, President Kennedy announced he was appointing a task force to review U.S. Government and private activities which adversely affect foreign purchases of the securities of U.S. companies. The group was composed of representatives of finance, business, and government. This task force, of which I had the privilege of serving as chairman, studied various courses of action which could be adopted in both the private and public sectors to encourage foreign ownership of U.S. securities.

In April 1964, the task force issued its report containing 39 recommendations, which called for a broad range of actions by U. S. international business organizations and financial firms, as well as by the Federal Government, to bring about broader foreign ownership of U.S. corporate securities. Among the recommendations directed toward the Government, those dealing with the taxation of foreign individuals and foreign corporations have the most significant and immediate impact.

Issuance of the task force report prompted a broad and intensive review by the Treasury of rules governing taxation by the United States of foreign individuals and foreign corporations. This review considered these rules not only from the standpoint of the balance of payments but also in view of conventional tax policy considerations. As a result of this review, on March 8, 1965, the Treasury Department submitted to the Congress proposed legislation containing proposals in all of the tax areas dealt with in the task force report, and also in other areas where it appeared that change was desirable to make the present system more consistent with rational tax treatment of foreign investment. The House Ways and Means Committee then thoroughly considered that bill, as well as several areas not covered by the bill, and, following public hearings, a new version of the bill (H.R.

11297) was introduced by Chairman Mills on September 28, 1965, and public comments on the revised bill were invited. The committee then further considered the matter in executive session and Chairman Mills introduced a revised version (H.R. 13103) on February 28, 1966. Following public hearings on March 7, 1966, H.R. 13103 was favorably reported out of the Ways and Means Committee and passed by the House of Representatives without opposition on June 15, 1966.

The Treasury Department agrees with the view expressed by the task force and in the House Ways and Means Committee report that many of the existing rules applicable to foreign investors in the United States are outmoded and inconsistent with sound tax policy and as a result deter foreign investment, to the detriment of our balance-of-payments position. These rules were enacted many years ago and do not reflect the changes in economic conditions which have occurred over the last 15 years.

Examples of tax rules which impede foreign investment in this country are many: The present level of our estate tax—much higher on foreigners than on U.S. citizens—is completely out of line with the rates generally prevailing elsewhere in the world and acts as a significant deterrent to potential foreign investors. Also, the fact that we require income tax returns from foreigners who only make passive investments here is inconsistent with international tax practice and hinders foreign investment in the United States. These and other aspects of our system of taxing foreigners contribute to the widely held view that investment in U.S. securities poses such serious tax problems for the foreign investor that it cannot be undertaken without the benefit of expensive tax advice. At the same time, some of these provisions are extremely difficult, if not impossible, to enforce, or are susceptible of relatively easy avoidance by the sophisticated foreign investor. Since they deter many foreign investors and are avoided by the rest, they give rise to almost no tax revenue.

However, this bill is not intended to convert the United States into a tax haven nor divert investment capital to the United States from less developed counries. The purpose of this bill is to provide equitable tax treatment for foreign investment in the United States. At the same time we recognize that this purpose will not be served if the bill violates proper tax policies or international tax standards, thereby setting off a competitive contest among the developed nations of the world to attract foreign investors through tax devices. To attract foreign investors, the United States must offer not "tax breaks" or "tax gimmicks"—it must offer a growing and dynamic economy. We believe our record of economic growth over the last 6 years and our prospects for the future are sufficient to induce a substantial increase in foreign investment if our tax system does not act as a bar.

Moreover, policies of this bill are consistent with the general policy of the United States which treats foreign capital on a basis of equality with domestic capital. Thus, there generally is no requirement that a foreign investor apply to U.S. authorities for permission to invest; the policy of the United States is to avoid interference with the right of foreigners to engage in particular types of economic activity in the United States; there are no legal provisions requiring the participation of domestic capital in foreign enterprises engaged in business in the United States; and the United States has no exchange controls, there are no restrictions on the remittance of business profits, or income from passive investments, and U.S. dollars are freely convertible in the market for any currencies and for all purposes; and the U.S. economy offers foreigners a safe, ready, and diversified investment market which has an outstanding record of economic growth.

The United States—with a GNP of $732 billion, personal consumption expenditures of $459 billion, business expenditures on new plant and equipment of $52 billion in 1965; an increase of $28 billion in GNP for the first half of 1966, the sixth year of our economic upswing, an open-door policy under which President Johnson said: "The United States warmly invites businessmen from other industrial countries to explore the many promising investments and licensing opportunities in the U.S.A."—offers to foreign investors an opportunity to take advantage of the potentials of investing in a great and growing marketplace. These investments will contribute to the long-range economic growth of the United States and the investing country. The bill should encourage such investments by removing certain tax obstacles involved in the present system.

Enactment of H.R. 13103 will result in a revenue gain of about $1 million annually. In addition, in the fiscal year 1967 only, it is expected that the bill will produce a revenue gain of approximately $22.5 million by reason of the provision requiring U.S. withholding agents to remit taxes withheld on payments to foreigners more frequently than on an annual basis, as is the case under present law. (See table I on p. 7 of the report of the Committee on Ways and Means on H.R. 13103, entitled "Estimated revenue changes resulting from the foreign investors tax bill.")

IMPACT OF H.R. 13103 ON THE BALANCE OF PAYMENTS

There is no way of estimating with any degree of precision the impact of the bill on foreign investment in the United States or the resulting benefit to our balance of payments. The factors governing securities investment are many and complex. Even in purely domestic transactions, intangibles such as habit, convenience, and past experience may be as important as yields, price-earnings ratios, and other economic indicators.

Although difficult to quantify, there is ample evidence of a sizable potential for attracting foreign investment in U.S. corporate securities, particularly stocks, by residents of the prosperous countries of continental Europe. After more than a decade of rapidly rising incomes, Europeans have to a large extent fulfilled many of their most pressing consumer needs and are accumulating savings at a high rate. Individuals in Europe are turning increasingly toward securities investment, as shown by the rising activity on European stock exchanges, the large number of new offices being opened in Europe by American securities firms, and rising sales of mutual fund shares. Yet, even now, in Europe only 1 person in 30 is a shareowner as compared to 1 in 11 in the United States.

At the end of 1965, foreigners held an estimated $12.5 billion of U.S. corporate stocks valued at market prices. In every year since 1950 except three, foreign purchases of U.S. stocks have exceeded foreign sales and in the 7 years between 1959 and 1965, net purchases by foreigners averaged $175 million (both excluding certain foreign governmental transactions). These net figures are the residual of total transactions which in recent years have been about $2½ billion to $3½ billion each year for both purchases and sales. A small percentage increase in such purchases, therefore, could have had a substantial effect on the net balance of transactions.

If the amount of additional investment expected to result from H.R. 13103 were merely a function of the amount of tax saved, there would be little improvement in the balance of payments. More important than any tax savings to foreigners, however, is the substantial effect which will result from the simplification and rationalization of our tax treatment of foreign investors. Our high estate tax on foreigners, for example, is widely considered by experts to be one of the biggest barriers to foreign investment. Existing estate tax rates almost certainly deter many foreigners from investing here at all. This is particularly so because the exemption is limited to only $2,000—nearly any investment whatsoever will subject the estate to tax and require filing of an estate tax return. It is not surprising under these complexities that the small foreign investor may avoid purchasing U.S. stocks because of the inconvenience of the estate tax; the big investor also may avoid such purchasing because of the size of the tax itself.

Viewed in this light, it is clear that the changes contained in H.R. 13103 should in time materially increase the volume of foreign investment in the United States. Based on the sizable potential for foreign purchases of U.S. corporate stocks which is known to exist, we expect that the legislation will eventually result in a meaningful additional capital inflow, other factors remaining unchanged. Some time—perhaps 1 to 2 years or maybe more—will be required before foreigners can reorient their reactions to the U.S. tax system and complete the adjustment of their portfolios to take advantage of H.R. 13103, but a substantial impact may be felt in the period ahead.

Mr. Chairman, I would like to interject at this point to say that in addition to the half dozen or so recommendations dealing with tax barriers that were in the task force report, many of the other 3? recommendations had to do with activities carried on by the private sector—industrial corporations marketing their securities abroad, securities firms opening up offices abroad, and many other things designed to further the purposes of this act. I think the committee would be interested in knowing that the private sector, since the report was made, has been very active in trying to implement the nontax recommendations that lie within the report's purview.

In the hearings before the House Ways and Means Committee a year ago last June, Mr. Robert Kinney, who was the executive director of the task force, included in the proceedings a detailed accounting of the efforts of the private sector to carry through these recommendations (beginning at p. 114 of the hearings). So we really come down in this bill to that part of the role of government which was considered most important in the task force report.

SPECIFIC PROPOSALS CONTAINED IN H.R. 13103

I should like to review at this time the principal substantive changes embodied in H.R. 13103.

Capital gains.—The present system of taxing capital gains realized by foreigners has contributed to the view that investment in the

United States is something which should be approached cautiously because of the possibility of inadvertently becoming subject to tax.

The Internal Revenue Code now provides for a general exemption from capital gains tax for nonresident foreigners not doing business in the United States with two exceptions. First, the foreigner's gains are subject to U.S. capital gains tax if he is physically present in the United States when the gain is realized, and second, all gains during the year are taxable if he spends 90 days or more in the United States during that year.

The physical presence restriction can be easily avoided by the experienced foreign investor if he arranges to be outside the country when the gain is realized, but is a potential trap to the foreigner who is not aware of its existence. The bill would eliminate this restriction from the general capital gains exemption.

In addition, the bill would extend the 90-day period which a foreigner may spend here without being subject to capital gains tax to 183 days. This will make the provision more consistent with international standards governing the taxation of foreigners residing in a country for a substantial period. It will also minimize a foreigner's fear that he will be taxed on capital gains realized at the beginning of a taxable year if he later spends a substantial amount of time in the United States during that year.

Graduated income tax rates.—At the present time, foreign individuals not doing business in the United States who derive more than $21,200 of investment income from U.S. sources are subject to regular U.S. income tax graduated rates on that income and are required to file returns. (Below that figure a flat 30-percent rate applies.) These requirements have produced little revenue, in part because we have eliminated graduated rate taxation of investment income in almost all of our treaties with the other industrialized countries and in part because of the relative ease with which this provision is avoided. However, the possibility of being subjected to graduated rate taxation and the accompanying return requirement may be a source of concern to foreigners and consequently act as a substantial deterrent to foreign investment in the United States.

H.R. 13103 eliminates this form of taxation of nonresident foreigners not doing business here and removes the requirement for filing returns in such cases. The liability of foreign investors deriving U.S. investment income would thus be limited to the tax withheld at the statutory 30-percent rate or a lower applicable treaty rate. The legislation would continue graduated rate taxation for foreigners who are doing business in the United States. These rules are consistent with the practices of most other industrialized countries.

Definition of "engaged in trade or business".—H.R. 13103 makes clear that nonresident alien individuals or foreign corporations are not engaged in trade or business in the United States—and thus are subject to tax at the 30 percent withholding rate or lower treaty rate rather than at regular graduated rates—because of investment activities here or because they have granted a discretionary investment power to a U.S. banker, broker or adviser. This provision should have the effect of removing much of the uncertainty which now surrounds the question of what amounts to engaging in trade or business in the United States. Uncertainty of this type is undesirable as a matter of tax policy and has the effect of limiting foreign investment in the United States. Many foreigners do not desire to invest in U.S. stocks if they cannot give a U.S. bank or broker discretionary authority to act for them.

The bill also changes present law by giving foreign individuals and foreign corporations an election to compute their income from real property on a net income basis at regular U.S. rates rather than at the 30 percent withholding rate or lower treaty rate on gross income. This type of treatment is common in the tax treaties to which the United States is a party and is designed to deal with the problem which arises from the fact that the expenses of operating real property (e.g., taxes, interest, depreciation) may be high and cannot be taken as deductions if the recipient of the income from such real property is not engaged in trade or business in the United States. It is sometimes difficult for a foreigner to determine whether his U.S. real estate activities constitute engaging in trade or business in the United States. Thus, taxation at higher graduated rates on a net basis, i.e., after allowable deductions, frequently results in a lower tax liability than taxation at a 30-percent rate (or lower treaty rate) on gross income without any allowance for deductions.

Segregation of investment and business income.—Under present law, if a foreign individual is doing business in the United States he is subject to tax on all his U.S. income, whether or not connected with his business operations, at regular graduated rates. H.R. 13103 would separate the business income of a foreign individual engaged in business here from his investment income (e.g., dividends, interests, royalties), and would tax the investment income at the 30-percent statutory withholding rate or at the lower appropriate treaty rate. All business income would remain subject to tax at graduated rates.

With respect to foreign corporations doing business in the United States (so-called resident foreign corporations), which also have investments here, H.R. 13103 would likewise separate the investment income from the business income of the foreign corporation. Under the legislation, a resident foreign corporation deriving such investment income from the United States would thus be taxable on such income at the statutory 30-percent rate or at the lower applicable treaty rate.

The bill conforms our treatment of investment income to the general approach followed by many other nations. It also is in accord with the Organization for Economic Cooperation and Development Model Income Tax Convention and the approach followed in our more recent treaties with the United Kingdom, Germany, and the Netherlands, and thus has the advantage of conformity to international practice.

The bill offers guidelines, which are supplemented by the legislative history, to the application of the "effectively connected" concept. A foreigner who is receiving investment income from the United States, under the approach of the bill would no longer have to be concerned that some other activity in the United States will suddenly be considered as attributing to him a trade or business status in the United States, thus subjecting the investment income to business taxation. Instead, as long as the investment income is not effectively connected with the other activity, any uncertainty as to the status of the latter would not color or affect the investment income. The removal of such uncertainty should encourage investments by foreigners in the United States.

As a result of the above-described changes, the foreign corporation engaged in business in the United States and also receiving dividend income would no longer automatically receive on those dividends the deduction now afforded under the Internal Revenue Code to dividends received by one corporation from another corporation. The elimination of the dividends received deduction in certain cases as respects resident foreign corporations is in part designed to end an abuse which has developed. Frequently, a foreign corporation with stock investments in the United States engages in trade or business here in some minor way and then claims the dividends received deduction on its stock investments—which results in the taxpayer paying tax at a rate of only 7.2 percent on the dividends (48 percent corporate tax on 15 percent of the dividends). Thus, such a corporation ends up paying far less than the 30 percent statutory or applicable treaty rate on its U.S. dividends, even though its position as respects its investment income is basically the same as a corporation which is not doing business here but which also derives investment income from the United States. In those cases where the applicable treaty rate is 5 percent (the rate set by certain treaties where subsidiary dividends are involved), the resident foreign corporation will benefit from this proposed change. Where the treaty rate is more than 7.2 percent and the dividend income is not effectively connected, the higher treaty rate will govern.

TAXATION OF FOREIGN SOURCE INCOME OF CERTAIN FOREIGNERS

The House noted that under present law certain foreigners can conduct business activities within the United States and not pay any tax to the United States (or frequently any other country) on the income derived from such activities. This is in contrast with the tax rules of other countries, which under comparable circumstances would tax active businesses with similar activities in their countries. To give the United States a parity of tax jurisdiction, and also to prevent the United States from being used in some cases as a kind of "tax haven" country because of the absence of that jurisdiction, the bill provides for the U.S. taxation of four limited kinds of income which are attributable to the conduct within the United States of a trade or business by a foreigner, even though the technical source of such income under our code rules is foreign. Under the circumstances covered, this provision is consistent with economic realities in attributing the profits to the U.S. business, and is in accordance with the practice of many member countries of the OECD.

The bill provides that such limited kinds of foreign source income of foreigners can be subject to U.S. tax only if the foreigner has an office or other fixed place of business within the United States to which such income is attributable. Thus, for example, under the bill a U.S. tax would be imposed where a U.S. branch of a foreign enterprise imports goods from abroad, solicits, negotiates, and performs other activities required in arranging the sale of such goods, and then resells the goods in the United States. Today the transaction may not be taxed by the United States if the sale is considered to take place outside the United States in view of the passage of title outside the United States (and it may not be taxed by the country of residence of the taxpayer if it does not tax its residents on income arising outside that country under the source rules of that country). In accordance with this tax treatment, the bill allows a foreigner whose foreign source income is so taxed in the United States a foreign tax credit for creditable foreign taxes paid on such foreign source income if the foreign tax is levied on the basis of source jurisdiction by the foreign country.

Personal holding companies and "second dividend tax."—H.R. 13103 changes the personal holding company provisions of the Internal Revenue Code as applied to the U.S. investment income of foreign corporations and also modifies the application of the so-called second dividend tax. Under the bill, foreign corporations owned entirely by foreigners would be exempt from the personal holding company tax as respects their U.S. income. This is desirable because of the elimination of graduated rates as applied to individual foreigners which is contained elsewhere in the bill, and which makes the application of the personal holding company provisions to corporations wholly owned by foreigners no longer appropriate since a withholding tax on its income has already been collected.

Under the bill, the "second dividend tax" (which under present law is levied on dividends distributed by a foreign corporation to its shareholders (whether foreigners or U.S. citizens) if the corporation derives 50 percent or more of its gross income from the United States) would be applied only to the dividend distributions of foreign corporations doing business in the United States which derive 80 percent or more of their business income from their U.S. business. It is desirable to retain this part of the tax to cover those cases where a resident foreign corporation has the great bulk of its business operations in the United States, so as to treat dividends of such a corporation as being from U.S. sources.

These changes should have the effect of eliminating application of the personal holding company tax and "second dividend tax" in many cases where they now apply, and where they may now act as a deterrent to foreign investment.

Bank deposits.—Under present law, interest on deposits with U.S. banks paid to foreigners not doing business within the United States is not subject to U.S. income tax and the deposit is not subject to estate tax. This is an exception to the general rule which subjects to U.S. income tax all interest paid by residents of the United States, corporate or individual. The House saw from the standpoint of tax equity no basis for such an exception but, because of balance-of-payments considerations, deferred the repeal of this bank deposit interest income tax exception until 1972. The repeal of the bank deposit estate tax exemption will become effective for decedents dying after the date of the enactment of the bill.

Where the interest is paid on a deposit of a foreigner in a foreign branch of a U.S. bank, the House liberalized the present bank deposit rule by providing that interest from such deposits with foreign branches of U.S. banks shall no longer be subject to U.S. tax except under limited circumstances. Under present law such interest income is subject to income tax when received by foreigners engaged in business within the United States; and subject to U.S. estate tax in the hands of nonresidents not citizens.

Senator TALMADGE. Mr. Secretary, would you yield at this point for a question or would you prefer to finish your statement?

Secretary FOWLER. Whatever the committee wishes.

Senator TALMADGE. I have received several letters from individuals both inside and outside my State strenuously objecting to this particular portion of the bill on the theory that at the end of 1965 we had some $13 billion worth of bank deposits in the United States, and they claim that if we imposed this tax it will have a very adverse effect on our balance of payments which this bill is supposedly designed to correct. They say particularly since an inheritance tax would be imposed immediately that many of them would withdraw their funds immediately. As I understand this provision, these funds would be taxable under the House bill in the year 1971 which would result in a most serious effect on our balance of payments. I would like to hear your comment on that.

Secretary FOWLER. Well, Senator Talmadge, as I indicated, the decision to terminate in 1972, the income tax exemption in the present law for bank deposit interest derived by foreigners not engaged in trade or business in the United States was made by the House Ways and Means Committee. It was not dealt with in the task force report.

The Ways and Means Committee felt, in effect, that no valid tax reason existed for continuing the exemption in the case of foreigners when U.S. citizens and residents are required to pay U.S. income tax on such interest.

As a matter solely of tax equity, I think the House Ways and Means conclusion appears to be correct.

However, because that decision may have current balance-of-payments implications—and recognizing that—the Ways and Means Committee postponed the effective date of the income tax until 1972, and said that at that time it would have an opportunity to reconsider the balance-of-payments situation. It is our understanding, Senator, that representatives of the banking community will appear before your committee and testify on this provision of the bill. They are, of course, much closer and much more familiar with the actual impact of this 1972 provision, and the current impact of the estate tax provision, than we are. Therefore, we are going to listen very carefully to their testimony. I am sure that it will be helpful to all of us in considering just what the effect is of this change in the law.

I do not have a concrete response to your question, except to urge that the committee give careful consideration to the testimony to be given by those who are more intimately familiar and directly concerned with this matter.

Senator TALMADGE. If I understand your reply correctly, you are neither for nor against the House provision.

Secretary FOWLER. Precisely.

Senator TALMADGE. Thank you.

Senator ANDERSON. Since there has been a pause here, where does this money come from in these banks?

Secretary FOWLER. It comes from all over, Senator Anderson.

Senator ANDERSON. Principally South America?

Secretary FOWLER. I was going to give you what information we have on this. I am now speaking of interest on deposits in U.S. banks paid to private foreigners as distinct from foreign central banks and foreign governmental institutions.

These time deposits, interest on which would become subject to income tax, according to our information, amounted to $2.5 billion at the end of May 1966. Of that amount, about $1.3 billion was held by Latin American residents. About half the Latin American holdings are in three countries—Argentina, Mexico, and Venezuela—which have free foreign exchange systems allowing residents to hold deposits in the United States or elsewhere.

Senator ANDERSON. Thank you.

Senator CURTIS. May I ask one question?

Senator ANDERSON. Surely, Senator Curtis.

Senator CURTIS. If these foreign deposits, deposits by foreigners in American banks become subject to tax, and as a result the depositors remove their money to other countries to have it free of the tax, in what countries could they make their deposits?

Secretary FOWLER. What are the other countries?

Senator CURTIS. Yes. Venezuela deposits money in Switzerland. Will the interest be subject to a tax?

Secretary FOWLER. The treatment varies. Our information indicates that in France they would be exempt from French tax if payable in a currency other than francs; in Germany, they would also be exempt; in Italy they would be taxable; in the Netherlands they would be exempt; in Switzerland they would be taxable. In the United Kingdom they would be——

Senator WILLIAMS. May I ask at what rate would they be taxed?

Secretary FOWLER. In Italy and Switzerland at a 27-percent rate.

Senator WILLIAMS. What rate would be proposed under the House bill?

Secretary FOWLER. Sir?

Senator WILLIAMS. What rate would the House bill propose?

Secretary FOWLER. Thirty percent unless the rate was reduced by treaty. In some countries with which we have treaties, Senator Williams, the interest would be exempt from tax.

Senator ANDERSON. Just a minute. What countries are principally treaty countries, then? Is Great Britain one?

Senator WILLIAMS. Those are the exempt treaty countries you are speaking of?

Senator ANDERSON. He put that in the answer so I thought it might all go in the answer at one time.

Secretary FOWLER. If I may, I would like to complete the answer to Senator Curtis' question giving the tax rates in three other countries and then answer the treaty question. In the United Kingdom, interest from bank deposits of foreigners are taxable at the rate of 41¼ percent, and in Canada at 15 percent—but I should note that in Canada when the deposit has been made in a foreign currency, and the interest is payable in a foreign courrency, no tax is withheld. The last country is Japan where bank interest of foreigners would be taxable at a 20-percent rate. So there are three major countries in which they are exempt, and five in which they are taxable.

Now, as to the countries with which the United States has treaties. Interest on U.S. bank deposits would be exempt in the case of payments to residents of the United Kingdom and taxed at 5 percent in the case of payments to residents of Switzerland under our treaty with Switzerland.

Senator WILLIAMS. Is that a reciprocal arrangement?
Secretary FOWLER. Yes, sir.
Senator WILLIAMS The same rate applies both ways?
Secretary FOWLER. Yes, sir; 10 percent with Japan; 15 percent with Belgium, France, and Canada; 30 percent with—well, 30 percent would apply to the Latin American countries, Argentina, Mexico, and Venezuela.
Senator WILLIAMS. Is it not true that——
Secretary FOWLER. May I make one comment on the United Kingdom. I am told, and I will have to defer to Mr. Surrey for this, that the United Kingdom apparently exempts interest on bank deposits in practice although in theory under the law it appears to be taxable at a 41¼-percent rate.
Senator WILLIAMS. Is it not true that if, for example, the Latin American investments should be deposited in Switzerland rather than here, the interest rates that they would receive would be relatively low, maybe 1 or 2 percent. In some cases don't they actually pay for the privilege of depositing their money over there? Secrecy is the point, not the interest rates.
Secretary FOWLER. That is my general understanding, Senator Williams.
Senator ANDERSON (presiding). Proceed, Mr. Secretary.
Senator CURTIS. May I ask one more question.
How long has the exemption existed?
Secretary FOWLER. I believe it was in the Revenue Act of 1921. According to the legislative history we have on it, it seemed to reflect concern for the competitive aspects—whether the banks here would be placed at a competitive disadvantage if it were not exempt.
Senator CARLSON. Mr. Secretary——
Senator ANDERSON. May I ask one question. Did that have anything to do with the financial condition in which this country found itself in 1921, with banks closing all over the country?
Secretary FOWLER. I cannot really give you a good answer to that Senator; I do not know. The only thing we have found is a reflection of a concern for the competitive situation of the American banks.
Senator ANDERSON. I know of one community which had six banks, and five of them closed. We kept the other one open by brute strength. Could that have had any effect, could that have played any part in this decision?
Secretary FOWLER. It might well have.
Senator ANDERSON. Senator Carlson.
Senator CARLSON. Mr. Secretary, on this income we have from deposits in banks, deposits from foreign countries, assuming we pass H.R. 13103, what would be the proposed rate?
Secretary FOWLER. In the nontreaty countries it would be 30 percent. I have indicated the rates for the treaty countries. Five percent in the case of Switzerland, 10 percent in the case of Japanese depositors, 15 percent for Belgium, France, and Canada, United Kingdom, and certain other European countries would be exempt, and in Latin American countries the full 30-percent rate would apply.
Senator CARLSON. The reason I bring that up, we, of course, have negotiated many treaties, but there are pending presently treaties before the Senate Foreign Relations Committee, and not only that, but

a great number of treaties are being negotiated, as I understand it, all over the world at the present time.

Assuming we in the Congress approved those treaties, would that not substantially change this 30-percent provision?

Secretary FOWLER. I do not think it would because the so-called less-developed-country treaties do not normally carry an exemption or reduction on interest.

Senator CARLSON. They normally do not carry interest?

Secretary FOWLER. They normally do not exempt interest from tax in the source country or reduce the tax on interest.

Senator CARLSON. My thought was if we approved this legislation that is pending and then enter into treaties with foreign countries we would actually vitiate what we thought we were doing on a 30-percent basis, was my point.

Secretary FOWLER. Yes. You would with a certain number of the developed countries, as I have indicated.

Senator CARLSON. That is all.

Senator ANDERSON. You may proceed, Mr. Secretary.

Secretary FOWLER. Estate tax. It is generally felt that our current system of taxing the U.S. estates (involving only the U.S. assets) of foreign decedents is inequitable and constitutes a significant barrier in our tax laws to increasing foreign investment in U.S. corporate securities. Under present law, a foreign decedent is taxable at regular U.S. estate tax rates, ranging up to 77 percent, on U.S. property held at death. Moreover, the U.S. estates of foreign decedents are entitled only to a $2,000 exemption compared with a $60,000 exemption available to U.S. citizen decedents. In addition, foreign decedents are not entitled to the marital deduction available to U.S. citizen decedents. As a consequence, a foreign decedent's estate must pay far heavier estate taxes on its U.S. assets than would the estate of a U.S. citizen owning the same assets. Moreover, U.S. estate tax rates applied to nonresidents are in most cases considerably higher than those of other countries and therefore foreigners who invest in the United States suffer an estate tax burden.

H.R. 13103 would increase the exemption for the U.S. estates of foreign decedents from $2,000 to $30,000 and would tax such estates on the basis of a 5- to 25-percent rate schedule. With this significant increase in the exemption and sharp reduction in rates, the effective U.S. estate tax rate on foreign decedents would be generally comparable to the effective rate of tax of a U.S. citizen who can utilize the $60,000 exemption and the marital deduction. This effective rate would no longer be considerably higher than most other countries, and would be more closely comparable to the rates prevailing elsewhere.

Senator WILLIAMS. Would not that formula give foreign decedents a lower rate than U.S. citizen decedents when the reduction in the rates on the larger estates is taken into consideration.

Secretary FOWLER. This would be on the higher——

Senator WILLIAMS. Yes; I am speaking of the 5- to 25-percent rate if we change that schedule. That would change it.

Secretary FOWLER. Let us take a U.S. gross estate of $500,000. Under the proposed law the effective rate on a nonresident alien would be 7.4 percent. In the case of a U.S. citizen with a marital deduction the rate would be 8 percent. In the case of a U.S. citizen without a marital deduction the rate would be 22 percent.

If the gross estate was $1 million, the effective rate of tax on a nonresident alien under the proposed law would be 10.1 percent. For the U.S. citizen with a marital deduction the rate would be 11.1 percent and for the U.S. citizen without a marital deduction the rate would be 26.7 percent.

Senator WILLIAMS. As to the person with a gross estate of $5 million, I notice in the table on page 43 that this bill would cut the estate tax to about 30 percent of the existing rate, and would put it at about half of the rate paid by American citizens.

Secretary FOWLER. Without the marital deduction.

Senator WILLIAMS. Yes.

Secretary FOWLER. A fair summary would be they are comparable where there is the marital deduction. The U.S. citizen without the marital deduction would pay a substantially higher rate.

Senator WILLIAMS. There is not such a reduction in the smaller estates, but in the larger estates there is practically a 50- to 60-percent reduction under this bill.

Secretary FOWLER. Yes; however, moving the exemption from $2,000 up to $30,000 would exempt the smaller estates.

Senator WILLIAMS. Of course, there has been a suggestion, and I do not know but there may be an amendment offered here, to raise the exemption in this country from its present $60,000 to $120,000. When was the present $60,000 exemption put into effect?

Secretary FOWLER. I do not recall.

Senator WILLIAMS. There has been quite a change in the value of the dollar since that time.

Senator ANDERSON. You would get a lot of support for that amendment.

Senator WILLIAMS. What would be the Treasury's position to the changing of that exemption, because I know that is going to be proposed to this bill?

Secretary FOWLER. Senator, I do not know what it would be at the moment. We have been engaged in a thoroughgoing study in the whole estate tax area, and we have not as yet arrived at a conclusion.

Senator WILLIAMS. This has been mentioned for the last 2 or 3 years. I think you would admit, would you not, if $60,000 was fair when it was first initiated it is far out of date under the existing valuation of the dollar?

Secretary FOWLER. I would prefer to say that I think that rather than deal with just one particular aspect of the estate tax, I think the whole area justifies a thorough reworking. At least that is the conclusion we have come to after about a year of fairly intensive study. That would be one aspect of it.

Senator ANDERSON. That is not an answer to Senator Williams' question.

Secretary FOWLER. No, sir.

Senator WILLIAMS. I gather it is somewhat like the answer you gave to Senator Talmadge before, you are neither for nor against?

Secretary FOWLER. That is right.

Senator WILLIAMS. We will settle for that answer, no position.

Secretary FOWLER. Well, I would be inclined to say that many other things ought to be taken into account before you act on one aspect of the estate tax.

Senator WILLIAMS. I think the whole rate structure of the estate tax should be studied carefully.

Secretary FOWLER. We think so, too.

Senator WILLIAMS. But I am not too sure it would be necessary to wait on that particular point because it is one that can very readily be understood and the merits can be appreciated on their own irrespective of what we may do with the other phase of it.

Secretary FOWLER. It could be quite expensive, and I am always concerned that when we remove some inequity we also try to compensate wherever we can by getting back the revenue. That is one aspect of the problem that disturbs me.

Senator WILLIAMS. I compliment you on the statement you just made. I only wish you felt the same way when we were cutting taxes. We would have been together then, too.

Senator ANDERSON. Mr. Secretary, on the amount that is available, by passing the marital reduction, didn't we substantially increase our $60,000?

Secretary FOWLER. It is about $120,000 as a practical matter now.

Senator ANDERSON. Yes.

Secretary FOWLER. And the marital deduction was adopted, I believe, in 1948.

Senator ANDERSON. 1948.

Secretary FOWLER. Since the war; yes, sir.

To get back to my statement, the change in the estate tax rates on nonresident aliens should have an important effect on foreigners contemplating investment in U.S. securities. Where the gross U.S. estate would be less than $30,000, there would be no estate tax, and no need to file an estate tax return. In those instances where the estate is larger, the effective rates would be substantially reduced. Thus, the top rate would drop from 77 to 25 percent, and the effective rates would be only 3 percent on a U.S. estate of $100,000 (the present effective rate is 17 percent), 7 percent on a U.S. estate of $500,000 (the present effective rate is 26 percent), 10 percent on a U.S. estate of $1 million (the present effective rate is 29 percent) and 18 percent on a U.S. estate of $5 million (the present effective rate is 43 percent).

Expatriate American citizens.—The provisions of H.R. 13103 which eliminate graduated income tax rates for foreign individuals and substantially reduce the estate tax liability of foreign decedents may create a substantial tax incentive to U.S. citizens who might wish to surrender their citizenship in order to take advantage of these changes in the law. While it is doubtful whether there are many who would be willing to take such a step, still the incentive would be present and might be utilized. In 1936 when the Congress eliminated graduated rates of tax on the U.S. income of former citizens, this action was reversed within 1 year because it was believed that this change had provided an incentive for expatriation to avoid tax. H.R. 13103 deals with this problem by providing that in the future an individual who has surrendered his U.S. citizenship for tax reasons within a preceding 5-year period shall be subject to U.S. taxation with respect to his U.S. income and assets at the rates applicable to U.S. citzens. Such individuals will therefore not receive the benefits of this legislation during such 5-year period but will be taxed substantially as nonresident foreigners are at present. These provisions will not apply unless the avoidance of U.S. taxes was one of the principal reasons for his surrender of citizenship.

Retaining treaty bargaining position.—By unilaterally making the changes applicable to foreigners provided in H.R. 13103, the United States could be placed at a considerable disadvantage in negotiating similar rules in other countries for Americans with income from foreign sources. In order, therefore, to protect the bargaining position of the United States in international tax treaty negotiations, H.R. 13103 authorizes the President, where he determines such action to be in the public interest, to reapply present law to the residents of any foreign country which he finds has not acted to provide our citzens with substantially the same benefits for investment in that country as those enjoyed by its citizens on their investments in the United States as a result of this legislation. If this authority were invoked, it could be limited to those investment situations as to which U.S. citizens were not being given comparable treatment. This provision of the bill is patterned on provisions presently contained in the Internal Revenue Code which attempt to assure U.S. persons appropriate tax treatment by foreign countries, e.g., section 891 which provides for doubling of U.S. rates on foreigners under certain circumstances; section 901(b)(3) which denies a foreign tax credit to alien residents of the United States unless a similar credit is allowed U.S. persons by their home countries. We believe that the presence of such a provision will be a material aid in our securing appropriate provisions respecting these matters in our international tax treaties.

In addition to the comments I have made on the existing bill I wish to recommend to the committee two amendments which will further the purpose of this proposed legislation.

The first of these would clarify the tax exemption on income from investments held by foreign central banks in securities or other obligations issued or guaranteed by the various agencies of the U.S. Government. The present language of section 895 of the code which provides for tax exemption on income received by foreign central banks on "obligations of the United States" leaves in doubt the status of some obligations of Federal agencies other than those of the Treasury. Interest in such investments has been shown by various central banks and it is clearly desirable to provide the broadest possible spectrum of investment possibilities in the United States in order to attract and hold foreign dollars which otherwise might be converted into gold. Also from the standpoint of marketing such issues it is in our interest to broaden the market by making them attractive to this type of large investor.

The second amendment would expand the authority of the Secretary of the Treasury to issue foreign currency denominated securities in the same range of maturities and interest rates as is authorized for regular dollar issues and in a manner which could benefit our balance of payments. The present legislation permits the sale of such foreign currency denominated issues only in the form of bonds and certificates of indebtedness whereas regular dollar issues may be offered in the form of certificates, bonds, and notes. Offerings in the 1- to 5-year maturity range are in the form of notes. The ability to issue notes in the foreign currency series of securities will make it possible for us to offer an attractive investment in the medium-term range of maturities since interest could be paid at rates comparable to that on regular

U.S. issues of similar maturity. I, therefore, propose that the word "notes" be added to present language of section 16 of the second Liberty Bond Act of 1917, as amended.

The Treasury Department also recommends certain amendments to the bill developed jointly by our staff and the staff of the Joint Committee on Internal Revenue Taxation. These proposals are described in a printed pamphlet entitled "Summary of House Bill and Suggested Technical Amendments," prepared for your use by these staffs, and therefore I will not describe them now.

CONCLUSION

Our current system of taxing foreign investors in the United States contains elements which are inconsistent with generally accepted international tax policy principles and which, at the same time, act to discourage foreign investment in the United States. H.R. 13103 is designed to reshape our present system in order to make it a more rational and equitable vehicle for taxing foreign individuals and corporations.

The legislation is an important element of the President's comprehensive program for dealing with our balance-of-payments problem. Foreigners will invest in this country as long as our economy remains prosperous and stable. However, it cannot be expected that the level of foreign investment will reach its full potential so long as provisions exist in our tax laws which, while serving no sound tax purpose, discourage foreign investors. H.R. 13103 will eliminate or modify these provisions and provide an up-to-date system of taxing foreigners which is in accord with international tax standards.

Adoption of H.R. 13103 will lead to a simpler, more rational, and more equitable method of taxing foreigners. It will also be an important step in improving our balance-of-payments deficit and the strengthening of the international position of the dollar. Because this legislation will contribute to these two vital national objectives, I urge you to support it.

Members of the committee, I have with me at the table Assistant Secretary Surrey, who has labored long and hard both in preparing the Treasury recommendations and working in executive session with the House Ways and Means Committee and the staff of that committee. This is a technical subject, and I will call upon Secretary Surrey from time to time to deal with some questions.

Assistant Secretary Winthrop Knowlton is here to assist in connection with questions that might involve balance-of-payments information.

Senator ANDERSON. Thank you for your statement, Mr. Secretary.

I think I can ask my questions by showing what Saturday's mail brought in on the subject. It is good reading, I might say.

Have you seen these documents put out by the New York State Bar Association and various firms?

Secretary FOWLER. No, sir, I have not. Perhaps Mr. Surrey is familiar with some of them.

Senator ANDERSON. It just seems to me that Mr. Surrey or somebody ought to go through some of these and try to decide whether their arguments are good or bad. I was quite impressed with the arguments.

Mr. SURREY. Senator, our staff is going through those documents with the joint committee staff to see if there are any technical changes we would like to recommend in addition to those listed in the pamphlet that has already been prepared for the committee.

Senator ANDERSON. I think that when somebody goes to the effort of preparing a 100-page pamphlet with what sounds like very good arguments in it, that the Treasury might supply us with a brief answer if they wished to do so.

Senator WILLIAMS. In line with that same question, it seems to me, Mr. Secretary, you are dealing here with a very far-reaching bill, and one which completely revises the present method of taxing foreign investment in this country. It is a complete revision, and a substantial reduction, for estate taxes, and income taxes as they will be paid by foreigners owning American investments, and I am wondering if this particular reduction in the estate tax provision, and some of these other reductions, should not be considered in light of what we are going to do in a revised tax proposal for our American citizens, and I——

Secretary FOWLER. Senator, I would hope you would not defer action on this bill. This bill, it seems to me, is long overdue. It is one which is designed to deal with the balance-of-payments problem—not in an emergency way, but as one of the paths to a long-term solution of the problem.

The task force report was originally made in the spring of 1964. The House committee thoroughly considered the bill all last summer, and comments were invited. There were hearings in June of 1965. This bill has been around a good long time. I would certainly hope that for balance-of-payments reasons, if for no other reason, that you would deal with it fairly promptly.

This does not mean that the estate tax problem as it applies to domestic persons is not an important one. As I have indicated to you, we have been working fairly intensively on it over the past year or so. But if we are going to try to review all the provisions of the code that affect domestic taxpayers, and get into that kind of a reform along with revising the tax on foreigners, we will never get this bill through.

Senator WILLIAMS. I am not saying that we should postpone it indefinitely, but I think you have given an excellent argument for the position I just suggested, because you said yourself that your task force studied this extensively in 1964, and that the House studied it throughout last year, and the early part of this year. But in the Finance Committee and in the Senate we are being presented with it here in the middle of August, just ahead of what we hope is going to be an adjournment and I am wondering if this committee has the time to really study and understand exactly what is proposed.

I was wondering if it would not be better if we worked out an agreement that this proposal, perhaps substantially in the form in which it presently is, could be presented to us in the early part of next year when we could give it the study it deserves rather than for us just to rubber stamp the proposal on a lot of suggestions which we are not going to have time to analyze.

Secretary FOWLER. Well, I really think that from the standpoint of the balance of payments, as I indicated earlier in my testimony, the private sector has been very energetic in trying to carry out their part of this task force report. Most of the comment that I get, quite frankly, is, "Why is the Congress holding this up?"

There seems to be no great disagreement about it. There was no opposition to it in the House. As far as the estate tax matter, the task force report recommended a revision which I am sure the Congress would never come to in dealing with estate taxes of domestic citizens. It recommended that you eliminate U.S. estate taxes on intangible personal property of nonresident alien decedents, and the grounds for it are contained on page 24 of the task force Report, which are simply that the balance-of-payments benefits that would be achieved so far outweighs the questions of whether or not this is in the proper equity relationship to domestic citizens that the members of the task force unanimously felt that it ought to be eliminated.

I signed that particular report feeling that way myself.

Senator WILLIAMS. When did you sign it?

Secretary FOWLER. That was in April 1964.

Senator WILLIAMS. That is right. That is 2 years ago, over 2 years ago, and now, this is the first time that I have had anyone from the Treasury Department suggest to me that this was an important measure to be dealt with this year.

Secretary FOWLER. It was in the President's message of February of 1965, Senator Williams. I would like to bring your attention to the specific paragraph, because it——

Senator WILLIAMS. That is the same message in which he said he was going to balance the budget; I think I remember the message.

Secretary FOWLER. No, this was the one of February 10, 1965, which outlined the whole balance-of-payments program. It included the so-called voluntary program on direct investment and on foreign bank loans. On page 7 of the report the President said:

> A truly worldwide market for capital among industrialized countries requires a two-way flow of investment in order to stimulate a greater inflow of capital from advanced industrial countries. The Secretary of the Treasury will shortly request legislation generally along the lines recommended by a Presidential task force to remove the deterrents to foreign investment in U.S. securities. This action will be reinforced and encouraged by the efforts of American business and finance to market U.S. stocks and bonds to foreign investors.

This proposal has been a matter of very great responsibility on the part of the financial community, both here and abroad, and it is viewed as a key element in dealing long term with our balance-of-payments problem.

Senator WILLIAMS. I do not question that the balance-of-payments problem is serious. In fact, I sometimes wonder if I am not more concerned than the Treasury, because one of my criticisms is that the Treasury does a lot of talking about the problem, but does little in the way of acting on the problem.

Now, Treasury recommends this bill as the solution to the balance-of-payments problem, but as always, it seems too little, too late. This is not going to provide the solution to the problem of the balance of payments.

Secretary FOWLER. There is not one solution. You have to deal with many facets of it, and this is an important facet of a long-term treatment of the problem. It is one which, in my judgment, is overdue as far as the Congress is concerned, if I may speak quite frankly. The Treasury has been pushing this. We have been anxious to get it through.

We have tried to do what we could to impress this upon the Congress. Obviously it was futile to ask this committee to hear it until the House finally acted. The House finally acted in June, and we have been urging that it be scheduled as soon as possible for hearings before this committee.

Senator WILLIAMS. I will withhold further questions at this moment.

Senator ANDERSON. May I comment here for just a second once again. One of these documents I received is from Brown Bros. & Harriman, sent to me by a former very fine member of the Senate, Prescott Bush, and I want to read just one part of it:

> We, therefore, urge that H.R. 13103 be amended by dropping the provisions of the tax on bank deposits; namely, that interest on such deposits will continue to remain exempt from Federal income tax and withholding and that such deposits continue to remain exempt from Federal and estate taxation.

That is the big item they have that is going to be the big fight before the committee before they report a bill out.

Can you tell me what your attitude would be on this if the bill was reported out without that provision, would you be for it?

Secretary FOWLER. Yes.

Answering Senator Talmadge's comments on it, I made note of the fact that this was a decision of the House Ways and Means Committee and that from the standpoint of tax equity the conclusion appears to be a correct one. But the decision also has very serious current balance-of-payments implications, according to the banking community who deal in this particular area. I would hope, without taking a position one way or another—because I am not in a position to make a judgment about this matter—that this committee would pay very careful attention to representations such as the one you referred to, and to the testimony which, I think, will be forthcoming from representatives of the banking community as to the impact of this deferred intention to remove the exemption which becomes effective in 1972.

Senator ANDERSON. I understand that you do not violently object.

Secretary FOWLER. No, sir; I do not either object——

Senator ANDERSON. If it should develop, Mr. Secretary, that we got stuck on these, you would not object in regard to the rest of this bill?

Secretary FOWLER. No, sir.

Senator CARLSON. Mr. Secretary, in your statement you mentioned that the Internal Revenue Code now provides for a general exemption in capital gains tax for nonresident foreigners doing business in the United States with two exceptions. These two exceptions you mentioned are, first, the foreigners' gains are subject to the capital gains tax if he is physically present in the United States when the gain is realized and, second, all gains during the year are taxable if he has spent 90 days or more in the United States during that year. This raises a question in my mind.

You mentioned in your statement, too, that many invest in mutual funds, they pay capital gains. How does that fit in under this bill? Would they be subject to tax under mutual funds, investments in mutual funds?

Secretary FOWLER. A foreigner investing in a mutual fund?

Senator CARLSON. Mutual fund. Presently they are not.

Mr. SURREY. Under this bill, if he is not present in the United States for 183 days during a taxable year he would not be subject to tax.

Consequently, a foreigner who lives abroad—one who does not come to the United States at all, which, I think, is the example you had in mind—would not be subject to tax.

Senator CARLSON. In other words, a foreigner could continue to invest in mutual funds and receive capital gains without tax.

Mr. SURREY. That is right.

Senator WILLIAMS. But if he lived in the United States 183 days, then he would be taxable under this bill.

Mr. SURREY. That is right. Today, if he lived in the United States 90 days he would be subject to tax.

Secretary FOWLER. If he were physically present when he sold out he would also be taxable under present law.

Senator CARLSON. You have been stressing your interest in our balance of payments, and I think we can all share this with you. But I was interested to read in the last issue of Business Week that—

> The Internal Revenue Service proposal to clarify tax laws affecting U.S. companies and their foreign affiliates is expected to boost shipments abroad.

And, of course, that is to boost exports which would be helpful in the balance of payments.

Secretary FOWLER. Yes.

Senator CARLSON (reading):

> The Treasury Department this week moved to clarify the hazy tax picture on transactions between a company and its domestic and foreign subsidiaries. The law, section 482 of this law, permits the Internal Revenue Service to adjust or allocate the incomes of various members of a group of firms under common control in order to reflect accurately the true income of the members to prevent tax avoidance.

What can you do, what have you done, under that particular section of the tax law?

Secretary FOWLER. We have announced and issued proposed regulations which will be subject to a hearing and comment over the weeks ahead.

The particular regulations that have been published for hearing and consideration are designed to deal with the concern that many American companies who do business with affiliates abroad have concerning the action of the Internal Revenue Service in levying an additional tax on the domestic company on the ground that too much of the profit, so to speak, has been passing over to the foreign affiliates. There has been a great deal of concern in the exporting community about section 482 and the proposed regulations are primarily designed to give clarity to the situation, to avoid any rigid hard-and-fast rules, and to provide guidelines for areas which seem to be causing most of the trouble.

We have tried in the regulations to stay clearly within the policy of law as the Congress intended, and yet, at the same time, to interpret the law and apply it in such a way as to clear up the confusion and to encourage the venturing out into the export field of American concerns and businesses. We will, of course, hear the comments from those who specialize in those areas, and then, in the light of those comments, the regulations will become effective.

I should say also, Senator, that we have studied carefully in this connection the report of the National Export Expansion Committee which is a committee established by the Department of Commerce. It has made three very substantial reports on how to encourage exports. We have taken the one dealing with this particular area very much into account.

Senator CARLSON. Under existing law, then, you are authorized and permited to deal administratively with this particular section of the law?

Secretary FOWLER. That is right—to allocate income and deductions between the domestic seller and his foreign affiliate.

Senator CARLSON. Then I get back just to one other question and that deals with treaties. Now, when we begin to negotiate treaties between countries, as we are doing and have done, does this section have any effect in this way, in a way that we will either take care of it in a treaty——

Secretary FOWLER. Not until fairly recently. Lately, however, it is my understanding that provisions have been included in our income tax conventions which in essence provides that the treaty countries will get together in an effort to prevent them from both taxing the same income if there is a section 482 type adjustment made which affects related companies.

Senator CARLSON. That is all, Mr. Chairman.

Senator ANDERSON. Senator Talmadge.

Senator TALMADGE. Mr. Secretary, do you know how much money foreigners have on deposit in banks, savings and loan associations, and insurance companies in the United States?

Secretary FOWLER. We have the figure on time deposits, Senator Talmadge, and that is two and a half billion dollars.

Senator TALMADGE. Do you have figures for other type deposits? One of my correspondents said the sum total of the three was $13 billion.

Secretary FOWLER. I think that includes all short-term banking liabilities to private foreigners, of which bank time deposits are only a part.

Within that larger total the private time deposits are two and a half billion dollars.

Senator TALMADGE. Let us look further into this problem and see how it might affect our balance of payments.

Assume that a citizen of South America has had deposits, for example in the Chase National Bank in certificates of deposit in the amount of $1 million. The interest rate now on this type deposit I think, is 5½ percent.

Secretary FOWLER. Yes, sir.

Senator TALMADGE. The interest on the $1 million over a period of 1 year would be $55,000, would it not?

Secretary FOWLER. That is right.

Senator TALMADGE. Now, if this bill passes in its present form it would be subject in 1971 to a 30-percent flat tax rate, would it not?

Secretary FOWLER. In 1972, it would be subject to a 30-percent U.S. tax rate. That is correct, sir.

Senator TALMADGE. That would be $16,500 he would pay on his certificate of deposit.

Assuming a citizen did not want to pay that tax, what would prevent him from withdrawing his money in the New York bank and transferring it to the same bank in Paris, France?

Secretary FOWLER. Nothing whatsoever.

Senator TALMADGE. In other words, that would mean if he were wise enough and had foresight enough and wanted to avoid this tax he would simply withdraw the $1 million he has on deposit in New York and transfer it to the Paris bank, thereby avoiding the tax and getting the same return, would he not?

Secretary FOWLER. That is correct, and I think I should add to that that most banks in Europe do accept dollar deposits from foreigners and pay about the same rate as is paid in the Euro dollar market, as it is called. The interest rate over the past year there has been ranging about a half percent higher than in the United States.

Senator TALMADGE. In other words, he would earn $5,000 more and escape the tax.

Secretary FOWLER. That is right, and to carry out the mathematics of your questioning, according to our computation the net return on deposits in these countries, if it is equal to the gross interest rate currently payable would be about 6½ percent on 3-month Euro dollar deposits compared to a gross yield in the United States of about 5½ percent and a net yield to a foreigner after application of the withholding tax, of about 3.85 percent.

Senator TALMADGE. Doesn't it seem to you logical that this particular foreigner would choose this course of action and increase his income by escaping the tax?

Secretary FOWLER. From my own simple knowledge of the situation I think it does present a case.

Senator WILLIAMS. Would the Senator yield at that point?

Senator TALMADGE. Yes.

Senator WILLIAMS. Assuming that the individual did that and deposited it in France, would he be subject to a tax in France, and would he have the same privileges of withdrawal and convertibility as he would have in this country or would he lose some of those advantages?

Secretary FOWLER. Insofar as the tax goes, Senator Williams, my earlier comments indicated that in France, Germany, and the Netherlands, he would not be subject to a tax in the source country. Insofar as convertibility goes, that is a much more complicated question. I do not want to hazard a comment on that, although my impression is that there is fairly free movement insofar as bank deposits are concerned.

Senator TALMADGE. Assuming, Mr. Secretary, that he made that transfer from the New York bank to the Paris branch of the same bank, would not that $1 million certificate of deposit be a factor in the further drain of our gold supply?

Secretary FOWLER. That is one of the consequences. There is a possibility of a gold impact from shifted dollar deposits.

Senator TALMADGE. Mr. Secretary, I listened to your testimony very carefully, and I think the main thrust of this bill would accomplish desirable ends, to increase investment in this country, and curtail our dollar drain. However, it seems to me that this particular provision of the bill which we have been discussing is calculated to do just exactly the opposite. Bank deposits are highly mobile in character. People are going to look for the highest possible short-range return, and if they can get a better return elsewhere and escape the tax, it is unquestionable that most foreigners would immediately transfer their deposits elsewhere to avoid the tax and get the higher return.

This probability is fraught with very grave danger, and so far as our dollar deficit is concerned, I would hope the Treasury would look into that aspect of it very carefully and be prepared to recommend to this committee, one way or another, what we ought to do about it.

Secretary FOWLER. Well, I think, Senator, it is a question of weighing the balance-of-payments consideration with the tax equity consideration—two very valid considerations. The House Ways and Means Committee gave a preeminence to considerations of tax equity as between domestic citizens and the other——

Senator TALMADGE. I would agree with that aspect of it completely. Certainly I would hate to see the United States of America grant preferential treatment to foreigners that is not given its own citizens. But the fact remains we have jurisdiction over American citizens and we do not over foreigners.

Secretary FOWLER. That is the observation I was going to make. The foreigner has an option—he can leave his money here or he can take it someplace else.

Senator TALMADGE. An American does not.

Secretary FOWLER. The American has a much lesser option, shall we say and, therefore, looking at it from a balance-of-payments standpoint, I think one views this provision with a considerable amount of concern.

Senator TALMADGE. Then you would have the further inequity that results from some American banks having foreign branches and some not.

Secretary FOWLER. That is another aspect of the problem.

Senator TALMADGE. So the American bank with foreign branches might not lose any deposits. It would merely shift from the American branch to the foreign branch. The foreigner would get increased income on his deposit, and escape the tax at the same time. But if the American bank had no foreign branches it would lose the deposit, which would also further complicate the dollar deficit crisis.

Secretary FOWLER. I think that is true. And I would imagine that one of the considerations that led the House to defer the effective date of this provision until 1972 was so that banks without foreign branches that were interested in this business could arrange to open foreign branches.

Senator TALMADGE. Thank you, Mr. Secretary.

Senator ANDERSON. Senator Dirksen.

Senator DIRKSEN. Mr. Secretary, I have one question. All the representations and all the mail I have received concern section (2) (c) (1) on page 12. The words are "effectively connected." They point out that foreign corporations doing business in this country but, at the same time, out of their home office in their own country they do an investment business, but they permit their New York office to collect a return, interest and principal, on foreign loan repayments and so forth. They are uneasy about what the interpretation of the proposed "effectively connected" is going to be. I have had mail from Asia, Europe, and any number of people in this country, and I swear that all the letters deal with just that item. I understand that it is on page 12 of the bill.

Secretary FOWLER. Yes, Senator Dirksen, this has been a phrase that has given rise to some concern. I am going to ask Secretary Surrey if he would deal with it. My understanding is that in the legislative history of the House bill an attempt has been made, in discussing this particular provision, to deal with many of the fears that might otherwise arise. Whether that has been effectively and adequately done in the legislative history, I do not know. I would defer to Mr. Surrey about that. But I would also think that in that connection the Senate report might well direct itself to an interpretation or a meaning of this phrase that would allay some of the concern that ought really not be there.

Mr. SURREY. Yes.

I think the Secretary's statement indicates the situation. In the case you gave where the foreign investor is doing business in the United States and is also investing in the United States, we were trying to achieve a device which would not subject his investment income to the higher rates of business tax except in those cases where that investment income was, as the bill says, tied in or effectively connected with his business.

It is a phrase which we are now using in our treaties with the Western European countries in conformity with the model draft which the OECD has written. We are extending it in this bill to all of the countries without waiting for treaties on this particular point.

Now, it is a new phrase in our tax language, and, consequently, there will be doubts at the borderline until some more experience is gained.

If we could look at the particular problems that have been addressed to you, Senator, we could see whether there could be language put in the Senate committee report to further clarify this phrase. We would be glad to help in that regard, although we had thought that the House report had removed most of the difficulties. As I say, it is a rule which is now evolving in our treaties, as well as in European treaties, when those countries are dealing with each other.

Senator DIRKSEN. Would it be advisable to expand the definition in the statute itself so that they would be fully on notice without having to depend on any Treasury regulations?

Mr. SURREY. If the language could be found, Senator. It is like the situation today where, for example, we use the phrase "engaged in trade or business in the United States." It is rather hard to expand upon language of that nature. It takes time to gain experience with the borderline cases. The phrase "effectively connected" is defined to some extent in the statute on page 13, so that there are some guides there.

We would not be adverse to improving the language in the bill or to adding language in the committee report if it would give people more guidance.

Senator DIRKSEN. That is all.

Senator ANDERSON. Senator Curtis.

Senator CURTIS. Mr. Secretary, is the provision inserted by the House with respect to bank deposits the only portion of H.R. 13103 which increases the tax burden?

Secretary FOWLER. No. There are some other provisions, Senator Curtis. For example, one has to do with insurance. I think foreign insurance companies have enjoyed a considerable competitive advantage over U.S. insurance companies under present law and the bill attempts to equalize the competitive position of foreign insurance companies, primarily Canadian companies, with U.S. insurance companies. That results in some increased revenue.

Senator CURTIS. Are there any others of significance?

Mr. SURREY. There is one other situation where a foreign corporation is engaged in business activities in the United States but because of our technical source rules the income is technically not within the present taxing jurisdiction of the United States. In three or four limited cases the United States under this bill will assert tax in these situations. It is impossible to estimate the revenue gain from that, but there will be some revenue gain.

Senator CURTIS. What will be the revenue gain from the House provisions in reference to bank deposits?

Secretary FOWLER. $300,000 is the only estimate currently. That has to do with the estate tax that now excludes bank deposits, but would, after the law is passed, include bank deposits. That is not an estimate of what would be the effect of the law in 1972 when the interest on bank deposits would become taxable.

On page 7 of the House report the elements of gain are calculated: $300,000 from the estate tax on excluded bank deposits; $3 million from taxation of foreign life insurance company income from nontrustee investments in the United States; and $1,593,000 from savings on interest costs to the U.S. Government resulting from the quarterly payment of withheld taxes. That last provision changes the rules on when taxes withheld from foreign persons are to be returned to the Treasury by the person collecting the tax. It accelerates that process.

Senator CURTIS. Is that a one-time gain or reoccurring?

Secretary FOWLER. Sir?

Senator CURTIS. Is that a one-time gain?

Secretary FOWLER. The interest costs each year are an annual gain. The one-shot benefit is about $22 million.

Senator CURTIS. So the gain on the table on page 7 of $4,893,000, is the continuing gain.

Secretary FOWLER. That is the continuing gain.

Senator CURTIS. I guess that is all, Mr. Chairman.

Senator WILLIAMS. I had one question. I passed before because the staff was working up a hypothetical case. But the question deals with this point, that under existing law a foreigner who has investments in this country is taxed pretty much at American individual tax rates, is he not?

Secretary FOWLER. Yes; I think that is a fair statement, subject to treaty arrangements.

Senator WILLIAMS. That is right.

A question has been raised as to whether or not, if this bill is passed in the form in which it is presented, we would be inviting the extremely wealthy individual in this country who wished to escape some of his income taxes and inheritance taxes to give up his American citizenship, go down to Nassau, spend 6 months of the year there, and return to the United States. Suppose such an individual had $100 million in investments in this country—and some of them do—with an annual income of $5 million from those investments. Instead of paying income tax at American rates, after he had lived abroad 5 years, he would be able to pay income tax at the lower rate under this bill. If he lived abroad for 10 years, his estate tax would be about one-tenth of what it is under existing law. I have asked the staff to provide a hypothetical case and to determine just how much difference it would mean on the annual tax rate, and on the estate tax for some individual.

Have you given any consideration to that point?

Secretary FOWLER. Yes.

Senator WILLIAMS. Now, there is a similar problem when an individual gives up his residence in one State and goes to another State to take advantage of a better tax climate. That is not so serious as an inducement for an American citizen to go abroad and to take advantage of a provision that in effect creates a special tax haven in the United States for foreign investment. Would that be possible, to what extent, and have you given it any consideration?

Secretary FOWLER. Yes, Senator Williams; we worried about this considerably. As a matter of fact, I think we, in executive sessions and in discussion of it, asked that the House committee provide 10 years in both cases. It is a matter of judgment as to what the appropriate period of years would be to be sufficient to meet this problem. The House committee came out with a recommendation that 5 years in the case of income tax, and 10 years in the case of the estate tax, would be the appropriate period. I have no particular quarrel with that judgment. I think the situation is as you presented it, and if this committee saw fit to make that period of time a longer period in order to deal with the problem, we certainly would not object.

Senator WILLIAMS. For the moment, we will skip the time element. As I understand the existing law it has no such loophole in it, but the adoption of this particular provision, in effect, creates a loophole whereby you are handing out an incentive for the wealthy of this country to give up their American citizenship and yet have the same protection of all their investments in this country without having to contribute toward the defense in the form of taxes. Do you think that is a wise policy for us to adopt for the first time here in America?

Secretary FOWLER. Under present law you still have this particular problem, because now a person can give up his citizenship, renounce it, and rid himself, so to speak, of his responsibilities under present law.

Senator WILLIAMS. Well, now, can he, assuming this same hypothetical case——

Secretary FOWLER. Perhaps you will give me this hypothetical case.

Senator WILLIAMS. This individual keeps his investments in this country and gives up his American citizenship under existing law, and say he complies with all the rules of living out of this country the specified time but when he dies, that individual will be taxed. If he had a gross estate of $10 million, he would be taxed at 53.3 percent, whereas under this bill he would be taxed at 20 percent or have his taxes reduced by around 60 percent. Now, there is a difference here. I mean under existing law he would pay the higher tax, would he not?

Secretary FOWLER. I would like to have Mr. Surrey answer that.

Mr. SURREY. It is a question of degree, Senator. If he is so determined as to give up his American citizenship to save taxes, then he can go on and be sufficiently resourceful in all probability as to make it very difficult for us to effectively collect those taxes, because foreigners today can, through the formation of corporations, in large part escape our estate tax, and also, in large part, escape our progressive rates of tax above 30 percent. So if he is sufficiently resourceful today he can do it.

This bill makes it harder for him to do it for 10 years in the case of an estate tax. It is harder for him to do it under this bill than it would be under present law in the estate tax cases. As I indicated, Senator, a foreigner today can escape our estate tax through a corporation. Now if an American wants to become an expatriate, and wants to really give up his citizenship to avoid our tax, he can do it through a corporation. Under this bill it will be harder because for a period of 10 years we look through a corporation to the assets underlying the corporation in the case of expatriates. So in that sense it will be harder for him, rather than easier, under this bill for a 10-year period.

Senator WILLIAMS. I agree with that, but I am speaking about the bill, that part of the bill which would make it easier.

Now the staff has just furnished me the figures on this hypothetical case of an individual who has an estate of $100 million, entirely with investments here in this country.

Now, according to the staff, under existing law this individual, even if he renounced his citizenship and died but with investments in this country, would pay an estate tax, with deductions of 10 percent and a $2,000 exemption, $67.7 million. Under this bill that estate tax would be reduced to $22.3 million.

Secretary FOWLER. If he had a good tax lawyer, Senator, he would form the foreign corporation that Mr. Surrey refers to, do it under present law, and be in better shape than he would be under this law.

Senator WILLIAMS. But we are plugging that loophole as you just said.

Mr. SURREY. For a 10-year period.

Secretary FOWLER. For a 10-year period, right.

Senator WILLIAMS. As we plug that loophole, why open up another one, because, according to the staff, this same citizen—and we are assuming that this $100 million investment here produces an income of $5 million—would be taxed at $3.1 million annually. After 5 years, by giving up his U.S. citizenship, he could reduce his tax to $1.5 million. He could cut it in half under this bill.

Is it wise to close one loophole and open another one at the same time? I form no opinion on it. I am just raising this question because it has been raised and the staff has just confirmed that we are, in effect, opening the possibility for wealthy individuals, and they are the only ones who change their residences from State to State, to give up their residence, live in Nassau, down in the islands, travel around the world for half the year, come back to this country half the time, and by so doing reduce their estate tax liability by approximately 70 percent and reduce their income tax liability by about half. I question the advisability of that at this time.

Mr. SURREY. Senator, the difficulty is that that person would subject himself to a 30-percent rate of withholding tax.

It has been very difficult for us, in practice, to enforce our progressive rates of tax beyond that on foreigners. Wealthy foreigners who want to invest in the United States and want to avoid their obligations to the United States have found ways through nominees, and through corporations and the like, to effectively reduce their U.S. income tax to 30 percent. It is doubtful if we can do better than that. So consequently today this person would likely find himself as a practical matter paying an effective 30-percent U.S. tax rate. This bill is likely for a period of 5 years to make us much more energetic and careful with respect to the expatriate because he is the fellow we are looking for in particular, and on whom we would concentrate. As Secretary Fowler said, we suggested the period be 10 years in the House.

All I am saying is that it is a conscious policy in this bill to do all that can be done within reasonable limits to reach the expatriate, but it is very difficult to go beyond a certain point. If people want to give up their citizenship, and in many cases wait for 5 or 10 years after that before they really receive a commensurate benefit, they are free to make that choice. I do not think there will be many who would want to do that.

Senator WILLIAMS. I do not question that, and I agree fully, as I understand it, that the bill would provide that greater control for the 5-year period, but why open it after a 5-year period? That is the point that disturbs me.

Secretary FOWLER. I think that——

Senator WILLIAMS. Why dangle a carrot for them to use later.

Secretary FOWLER. The whole purpose of the bill is to make it attractive for foreigners to invest in the United States. Now if you are going to achieve that particular objective, and if it is a desirable one, you have this incidental problem of the expatriate to deal with. We have tried to deal with it in the manner described because we think the advantage of the bill in terms of the authentic foreign investor far outweighs the disadvantage that might accrue by the fact that sporadically an American might renounce his citizenship in order to achieve some tax advantage.

However, we have gone further than that and not just left it on that particular balance, but by these 10-year and 5-year provisions—10-year for the estate tax and 5-year for the income tax—tried to weight the scales against that judgment.

Now, if it is the judgment of this committee that these yearly periods do not put sufficient weight on the scale. I think the Treasury's instincts would be to extend the number of years. That was our position in the House.

Senator WILLIAMS. That is the point. What years did you suggest or do you suggest?

Secretary FOWLER. Ten and ten.

Senator WILLIAMS. Ten and ten.

Secretary FOWLER. In the House, yes.

Senator WILLIAMS. What about 10 and 20? Do you think you should leave any financial attraction at all to an American citizen to give up his citizenship?

Secretary FOWLER. I certainly have no desire to propose that there be some limit. If the committee feels that the 10- and 5-year periods selected by the House are not adequate, I would not object and would go along with it if the committee wished to extend the period.

Senator WILLIAMS. As I understand it, you recognize this could be a potential loophole and you would have no objections to it being tightened or closed if this committee saw fit.

Secretary FOWLER. No, sir.

Senator WILLIAMS. I appreciate that.

Senator ANDERSON. Senator Curtis.

Senator CURTIS. I have one question.

Coming back to the increased revenue by taxing interest on deposits in U.S. banks, let us assume that the interest paid on deposits to foreigners in the year 1962 remains at the present rate, at the present level, and that the tax rates remain the same. What would be the increase in revenue in 1972?

Secretary FOWLER. About $22.5 million. That is if all the deposits remained here—I had better give you my assumptions—if all the deposits remained here and the rate of interest was 4 percent, the tax on such interest would total about $22.5 million.

Senator CURTIS. Did I understand Senator Carlson to say that the return paid on mutual funds falls under this same provision of the bill? That is not regarded as interest, is it?

Mr. SURREY. No, sir.

Senator CURTIS. That is treated as an equity investment.

Mr. SURREY. Yes.

Secretary FOWLER. Thank you.

Senator CURTIS. Thank you, Mr. Secretary.

Senator ANDERSON. Mr. Chapman, I regret you waited so long, but we had a long examination of the Secretary. We have some important bills on the floor. You go right ahead.

STATEMENT OF ALGER B. CHAPMAN, VICE PRESIDENT, NEW YORK STOCK EXCHANGE; ACCOMPANIED BY STANLEY WEST, RESEARCH DIRECTOR

Mr. CHAPMAN. Thank you, Senator Anderson. My name is Alger B. Chapman. I am a vice president of the New York Stock Exchange. With me today is Stan West, research director of the exchange.

I want to thank the committee for affording the exchange this opportunity to appear on behalf of its membership in support of the proposed Foreign Investors Tax Act of 1966. Unfortunately, when the committee's announcement of the hearings was received last week, Mr. Funston, president of the exchange, was on board ship between California and Hawaii, and his plans were such that it was impossible for him to be here today. He has asked me to make his personal apologies to the committee because if it had been possible, he would have wanted to deliver his statement in person.

As a member of the Presidential task force on promoting foreign investment and increased foreign financing, Mr. Funston feels very strongly that this bill should be enacted. But he also urges adoption of the amendments suggested in his statement, so that foreign investment will be further encouraged in the United States with a resulting beneficial effect on our balance of payments.

I have filed for the committee's information, and ask that it be included in the record, copies of Mr. Funston's statement, and accordingly I do not plan to read it to the committee. However, I would like to take just a few minutes to summarize the various points it contains.

First, the bill with the modifications we suggest can be a decisive factor in increasing the flow of foreign funds to this country. If U.S. taxation of foreign investors is eased, other inhibiting factors are alleviated, and our private selling efforts are reinforced, the savings flowing here for investments from other countries should increase substantially the benefits to our balance of payments.

A number of provisions in the bill remove barriers to increased foreign investments, and we urge that they be adopted. They are elimination of the requirement that foreigners file a tax return for income above $21,200; elimination of the risks that a foreigner may be treated as doing business in the United States if he gives power of attorney to a U.S. resident; application of capital gains taxation to a foreigner only if he is present in the United States for 183 days or more per year; and, finally, reduction of the estate tax rates on foreigners.

The committee should be alerted to the risk that some of the restrictive provisions of the bill could lead to large withdrawals of foreign funds from U.S. banks, thus hurting our balance-of-payments position. The committee should also be aware that a number of provisions in the bill may act as a deterrent to foreign investment in the United States, rather than providing a stimulus which is intended to help our balance of payments. Certain changes would avoid these dangers.

In the estate tax, the simplest and most effective step would be to eliminate the estate tax on foreigners completely. This would provide a much greater stimulus for foreign investment in the United States than a rate reduction, and it would help our balance of payments because many people feel that elimination of an estate tax would open up the vaults of Europe, and would produce a dramatic inflow of funds into the United States.

Second, if estates continue to be taxed, retain the situs rule on bonds. Under the present law, bonds issued by U.S. persons are only subject to the estate tax if located in the United States. Under H.R. 13103, all debt obligations of a U.S. person, U.S. Government, or State or local governments and owned by foreigners, will be subject to the estate tax no matter where their physical location.

Under the administration's voluntary program to reduce capital outflow, American companies are being urged to finance their oversea investments through local borrowing. During 1965 and in the first quarter of 1966, some $600 million of such borrowings were financed through bond issues outside of this country. The proposed changes in the situs rule would jeopardize this program by making foreign investors reluctant to purchase these bonds, as well as others issued in the United States, if they will be subject to U.S. estate taxation.

Third, exclude from property consideration taxable customers' cash balances at brokerage houses awaiting investment or reinvestment. These balances are similar to deposits in banks and savings and loan associations and—for estate tax purposes—they should be treated in the same way.

Fourth, exempt permanently bank deposits of foreigners. In the area of the income tax, delete the provisions of the bill which, after 1971, would impose income tax on deposits of foreigners not doing business in the United States.

Fifth, reduce and consider discontinuing the withholding tax levied on interest and dividends paid to foreigners. As a minimum step, the committee should urge the administration to press for mutual reductions with other countries in the percentage withheld through treaty arrangements.

Sixth, eliminate the tax imposed on foreign pension trusts and similar institutional investors, such as charitable organizations, and at the very least urge the administration to ease the procedures involved in qualifying these organizations for tax exemption. The difficulty in qualifying for tax exemption, even though it is afforded under the tax laws, is such that many foreign institutions refrain from investment in U.S. securities.

Permit foreign bank branches in this country to treat income from investment portfolios of U.S. securities as effectively connected with the trade or business in the United States, so that they can continue to take the deductions they are permitted under current law. Failure to do this could lead to a substantial liquidation of their holdings of U.S. securities.

The theme of Mr. Funston's statement is quite basic. The bill before the committee eliminates a number of tax deterrents to foreign investment in the United States. However, at the same time, it creates some new deterrents. In order to obtain the maximum impact on our balance-of-payments position, we recommend that the new deterrents to foreign investments should be eliminated from the bill and the additional incentives we propose be incorporated in the bill.

Thank you very much. If there are any questions, Mr. West and I will try to answer them.

Senator ANDERSON. In the statement of Mr. Funston, he refers again to this "effectively connected."

Mr. CHAPMAN. Yes.

Senator ANDERSON. You heard some discussion of it. Did that satisfy you?

Mr. CHAPMAN. Yes.

Senator ANDERSON. You think we ought to get a definition so everybody could understand it.

Senator Curtis?

Senator CURTIS. I think not. In light of the hour, I will refrain from questioning.

Senator ANDERSON. Thank you very much, Mr. Chapman. It is a good statement and we will include Mr. Funston's statement in the record.

Mr. CHAPMAN. Thank you very much.

(Mr. Funston's statement referred to above follows:)

STATEMENT OF G. KEITH FUNSTON, PRESIDENT, NEW YORK STOCK EXCHANGE, ON H.R. 13103

SUMMARY

The New York Stock Exchange vigorously supports the basic philosophy of H.R. 13103—"The Foreign Investors Tax Act of 1966"—to increase incentives for foreigners to invest in the United States. The bill, with the modifications we suggest, can be a decisive factor in increasing the flow of foreign funds to this country. If U.S. taxation of foreign investors is eased, other inhibiting factors are alleviated, and our private selling efforts are reinforced, the savings flowing here for investment from other countries should increase substantially—to the benefit of our balance of payments.

The bill, as originally introduced, embodied many of the recommendations of the Presidential Task Force (headed by now Secretary of the Treasury Fowler) on Promoting Foreign Investment and Increased Foreign Financing. One of the stated objectives of the Task Force was "to help establish conditions under which restraining influences on capital flows between the industrially advanced nations * * * can be removed, diminished or allowed to expire."

The problem of these capital flows is forcefully demonstrated by what happened during the last two years. In 1964 and 1965, partly because of the indirect effects of the Interest Equalization Tax, foreigners were net sellers of $635 million of U.S. corporate stocks and bonds. Even before imposition of the Interest Equalization Tax, however, the outflow of U.S. funds for investment in foreign securities almost invariably exceeded the inflow of foreign funds for investment in U.S. securities. There is clearly a need, therefore, to take steps which will attract more foreign investment to the U.S.

In general, H.R. 13103 simplifies the present complicated and sometimes unenforceable tax law governing foreign individuals and corporations. This is accomplished in the bill by changing the existing law to:

(1) Relieve foreigners of the need to file a return for income above $21,200.

(2) Eliminate the risk that a foreigner may be treated as doing business in the United States by giving a power of attorney to a United States resident.

(3) Exempt a foreigner from capital gains taxation unless he is present in the United States for at least 183 days.

Although the Exchange applauds the bill in principle, we are impelled to point out serious reservations about a number of provisions which conflict with the bill's over-all objective—aiding our balance of payments position and stimulating foreign investment in the United States. The Committee should be alerted to the risks that some of the restrictive provisions of the bill could lead to large withdrawals of foreign funds from United States banks in favor of either of foreign branches of such United States banks or foreign banks. This could mean an outflow of dollars unfavorable to our balance of payments position.

The Exchange, therefore, suggests the following deletions, amendments and additions to H.R. 13103:

(1) Eliminate the estate tax on nonresident aliens completely, rather than providing only a rate reduction.

(2) If estates continue to be taxed, retain the situs rule on bonds.

(3) Exclude brokerage customers' cash balances awaiting investment or reinvestment from property considered taxable for estate tax purposes.

(4) Permanently exempt from the estate tax bank deposits of foreigners and also delete the provision which would make interest on deposits of foreigners not doing business in the U.S. subject to income tax after 1971.

(5) Discontinue or reduce the withholding tax levied on interest and dividends paid to foreigners. As a minimum step, press for mutual reductions with other countries in the percentage withheld through treaty arrangements.

(6) Eliminate or ease taxes imposed on foreign pension trusts and similar institutional investors.

(7) Permit foreign bank branches in this country to treat income from investment portfolios of U.S. securities as "effectively connected" with a trade or business in the U.S.

The Exchange specifically endorses the language in Section 2 of the bill referring to "Trading in Securities and Commodities," as revised from the original Administration proposals. The revised language of H.R. 13103 clarifies the intent of the legislation and eliminates any risk of misinterpretation.

OBJECTIVES OF PENDING BILL

H.R. 13103, "The Foreign Investors Tax Act of 1966," accepts the basic philosophy and recommendations of the Presidential Task Force on the Balance of Payments, of which I was a member. The Task Force recommendations were originally embodied in H.R. 5916, submitted by the Administration to the Congress for consideration in 1965. In its statement on H.R. 5916, the Exchange noted that:

"Adoption of this legislation would do much to stimulate the long-term flow of foreign capital to the U.S., in part by removing archaic restrictions on the flows. The securities industry has long advocated removal of such restrictions. The Exchange applauds the fact that the proposed legislation will enhance the freedom of movement in the international flow of capital funds."

The legislation, appropriately cast, should aid our balance of payments problem. As the late President Kennedy observed in his last balance of payments message to the Congress, "Securities of U.S. private firms could be and should be one of our best selling exports." This proposed legislation, by removing some bothersome and complex restraints, should make the sale of American securities to foreign investors considerably easier.

While the Exchange supports the basic philosophy of the bill, and the bill includes a number of desirable features, we do have serious reservations about several provisions which are not consistent with the bill's over-all objective—aiding our balance of payments and stimulating foreign investment in the United States. The Committee should be aware of the possibility that some of the bill's restrictive provisions could lead to large withdrawals of foreign funds from United States banks in favor either of foreign branches of such United States banks or foreign banks. This could mean an outflow of dollars unfavorable to our balance of payments position. Therefore, if these provisions are not modified, the legislation might well produce unfavorable, rather than favorable, reactions in the financial markets of the world and on our balance of payments.

SUGGESTED REVISIONS

Although the unfavorable impact of the changes effected between the original bill (H.R. 5916) and its second version (H.R. 11297) has been softened in the current version, the legislation's basic purpose of stimulating foreign investment in the U.S. may well be blunted if further changes are not made.

The legislation as written can be materially strengthened in several ways, as discussed below, and moved closer to its objective, as outlined by the Balance of Payments Task Force, of removing existing deterrents to foreign investment. In addition, the effectiveness of a program to encourage foreign investment in U.S. securities may be enhanced by adoption of several measures not included in the tax bill.

Consequently, the Exchange suggests the following adjustments and additions:

I. ELIMINATION OF ESTATE TAX ON NONRESIDENT ALIENS

Under present law, the estates of nonresident aliens are taxed at rates ranging from 3% to 77%, with a specific exemption of $2,000. Section 8 of the bill, by raising the specific exemption and lowering tax rates, reduces the estate tax rates to between 0% and 40% of present levels, thereby taxing nonresident aliens at about the same rates as U.S. citizens who claim a marital deduction. We feel the bill should go further and completely eliminate estate taxes on nonresident aliens. This would provide a much greater stimulus to foreign investment in the U.S. than a rate reduction, and be a much greater help to our balance of payments. Many feel elimination of estate taxes would open up the vaults of Europe and produce a dramatic inflow of funds to the U.S. The reasons are twofold: First, many foreigners are discouraged from investing here by the existing requirement that they file estate tax returns. This deterrent would be removed if the tax were eliminated. Second, since even the proposed lower tax rates are higher than those now levied in many other countries, investment by residents of those countries would continue to be discouraged.

The rates proposed in the bill are higher than the ones originally suggested by the Administration, and stop far short of the Task Force recommendation to "eliminate U.S. estate taxes on all intangible personal property of nonresident alien decedents." Though the proposed rates would be below those levied on resident estates in the United Kingdom, Canada and Italy, they would be higher than those imposed in Switzerland, Germany, France and The Netherlands. Thus, the legislation favors the residents of some countries while discriminating against those of others.

Elimination of the estate tax on nonresident aliens would lead to a very small revenue loss. The tax has produced revenues of $4 to $5 million annually in recent years, and would probably yield no more than $2 million under the proposed legislation. An additional revenue loss of $2 million would be a small price to pay for the removal of a major deterrent to foreign investment in the U.S. The benefits of the change to our balance of payments would be ample compensation for the revenue loss.

II. RETENTION OF "SITUS RULE" ON BONDS

Under the present law, bonds issued by United States persons are subject to the estate tax only if such bonds are located in the United States. Under H.R. 13103 all debt obligations (including bonds) of a United States person, the United States, state governments or any political subdivision of a state are deemed to be property within the United States independent of their physical location, and as such, are subject to the estate tax.

The stimulus given to foreign investment in the U.S. by the reductions in the estate tax rates could in part be negated by this change in the situs rule. The result of a change in the rule would be decidedly adverse to the U.S. balance of payments. Therefore, the Exchange urges that the situs rule regarding bonds not be changed.

Under President Johnson's voluntary program to reduce capital outflows, American companies are being urged to finance their overseas investment through local borrowing. About $600 million worth of bonds were floated abroad in 1965 and the first quarter of 1966 in response to the President's appeal. The proposed change in the situs rule could jeopardize this program by impeding the efforts of American firms to finance their overseas expansion in foreign capital markets. Foreign investors would clearly become reluctant to purchase bonds of American companies if this exposed them to United States estate taxation.

Moreover, it would be extremely difficult administratively to enforce this change in the law. Since bonds are generally issued in bearer form, we know of no practical way of identifying their owners for tax collection purposes.

III. EXCLUSION OF CUSTOMER'S CASH BALANCES FROM ESTATE TAXATION

Under present law, foreign customers' cash balances with brokers are subject to U.S. estate taxation. The Exchange suggests that, if foreigners remain subject to the estate tax, Section 2105 of the Internal Revenue Code should be amended so that *all* funds awaiting investment not be considered property within the U.S. for estate tax purposes. This should apply not only to deposits in banks and savings and loan associations, as discussed below, but also to the "counterpart" to such deposits in the securities industry—customers' cash balances held by brokers awaiting investment or reinvestment.

IV. REVISED TREATMENT OF BANK DEPOSITS OF FOREIGNERS

Under the present law, interest received by foreigners from funds on deposit in the U.S. with persons engaged in the banking business or with some state-chartered savings and loan associations is considered as non-U.S. income and is currently exempt from United States taxes. Similarly, the principal amount held for foreigners by all banking institutions is exempt from United States estate taxes. H.R. 13103 changes these provisions and makes such interest taxable, whether or not the foreigner is engaged in business here, and also subjects the principal to the estate tax. But, in recognition of the current balance of payments problem, the bill defers the taxation of such interest until after December 31, 1971.

This recognition of the balance of payments problem, however, is not carried forward in the estate tax provision. Even though the interest collected is not subject to income tax until after 1971, the deposit itself becomes subject to estate tax on the effective date of H.R. 13103.

Both of these changes would surely lead to a sizable outflow of foreign capital. Knowledgeable bank officials have estimated that several billion dollars of bank deposits would be potentially subject to either the estate tax or to annual taxation of interest income if the proposed legislation becomes law. It seems reasonable to assume that a large part of these deposits would then be withdrawn over time from banks within the U.S. There is every reason to assume that these deposits would not be shifted to foreign branches of U.S. banks. Even if they were, the transfer would represent a capital outflow in the balance of payments.

Consequently, the Exchange strongly urges that the proposed legislation be revised to omit those sections which change the treatment of bank deposits of foreigners. An impediment to the free flow of international capital funds would thereby be avoided, and our balance of payments position remain unaffected.

V. DISCONTINUATION OF WITHHOLDING TAXES ON INTEREST AND DIVIDEND PAYMENTS

Present law requires the withholding of income tax on dividend and interest payments to foreigners. This acts as a deterrent to foreign investment in U.S. securities. To remove this obstacle and help improve the balance of payments, the Exchange recommends that the pending bill be amended to eliminate these withholdings taxes.

If the potential revenue loss makes repeal undesirable, the U.S. should press through treaty arrangements for mutual reduction in the withholding tax with as many foreign countries as possible. Since transactions in outstanding securities have generally produced an inflow of funds to the U.S., mutual reductions in the withholding rate could be expected to stimulate foreign purchases of U.S. securities to a greater extent than they would U.S. purchases of foreign securities—even when the adverse effect of the Interest Equalization Tax is taken into account.

VI. ELIMINATION OR EASING OF TAXES ON FOREIGN PENSION TRUSTS

U.S. income taxes imposed on foreign pension trusts and similar investors should be eased. Domestic pension funds enjoy a tax exemption on their investment income. Foreign pension funds, even though qualified for an exemption, can obtain it only by going through the difficult procedure of obtaining approval from numerous agencies of the U.S. government. As a result, these investors are discouraged from investing here, especially if they are exempt from taxes in their country of domicile.

Pension funds in some foreign countries have grown dramatically in recent years. For example, the Joint Economic Committee study of European capital markets showed that pension funds in Great Britain have been one of the fastest growing institutions in that country's financial structure, and had investments of $10 billion at the end of 1962.[1] Further growth is fully expected. It seems reasonable to assume that a considerable capital flow into the U.S. might be stimulated if foreign pension funds were accorded a tax treatment similar to that enjoyed by domestic funds. Further, the Treasury in its regulations can provide any safeguards necessary to prevent abuse of this legislation.

Consequently, taxes on the income of foreign pension funds and similar institutional investors should be eliminated by law. As a minimum step, the U.S. should work with other countries toward the mutual elimination of taxes on these types of investors.

VII. TREATMENT OF FOREIGN BRANCH BANKS' PORTFOLIO INCOME AS "EFFECTIVELY CONNECTED"

The present law generally taxes nonresident aliens and foreign corporations at the regular individual or corporate rates on all their U.S. source income, if they are engaged in trade or business in this country. If not so engaged, they are taxed at a flat 30% rate or lower treaty rate on all fixed or determinable income. The bill would generally subject the income of a nonresident alien or foreign corportation to the flat 30% or lower treaty rate, if the income is not effectively connected with the conduct of a trade or business in the United States.

Some foreign banks with branches in the United States may suffer adverse effects under the different tax treatment proposed for income "effectively connected" and that "not effectively connected" with the conduct of a "trade or business" under Sections 881 and 882. The income from their investment portfolios of U.S. securities is usual and necessary to an ordinary commercial banking operation. If it is treated as "not effectively connected," the tax will be on the gross income without the allowance of any deductions properly allocable to such income. Such a tax on gross income could have a confiscatory effect upon the portfolio income of foreign banks, since there are generally significant deductions which would otherwise be attributable to such income.

The Exchange believes that foreign banks with branches in the U.S. should have the election of treating the income from their investment portfolios of U.S. securities as "effectively connected" with a trade or business, so that they can have the benefit of deductions which are allocable to such income. Unless an amendment of this type is included, treating such income as "not effectively connected" with the conduct of a trade or business would have a substantial adverse effect on the willingness of such foreign banks to have their U.S. branches hold domestic securities.

CONCLUSION

As noted in the Report of the House Ways & Means Committee, "H.R. 13103 is designed to provide more equitable tax treatment for foreign investment in the U.S." The purpose of the legislation, as initially introduced, was to "stimulate foreign investment in the United States by modifying existing tax rules which

---

[1] U.S. Congress, Joint Economic Committee, *A Description and Analysis of Certain European Capital Markets*, 1964, page 238.

are not consistent with sound tax policy and act as barriers to such investment."

The Exchange, in endorsing the spirit of the bill, believes that our suggested changes, amendments, and additions would greatly enhance the effectiveness of the legislation. Through the adoption of these suggestions, the Congress would be better able to achieve the original objective of aiding our balance of payments position by removing present deterrents and in addition providing positive incentives for foreign investors.

Senator ANDERSON. Robert Norris.

STATEMENT OF ROBERT M. NORRIS, PRESIDENT, THE NATIONAL FOREIGN TRADE COUNCIL, INC.; ACCOMPANIED BY CHARLES R. CARROLL, COUNSEL TO THE BOARD OF DIRECTORS

Mr. NORRIS. Senator, my name is Robert M. Norris, president, National Foreign Trade Council, and I am accompanied by Charles R. Carroll, counsel to the board of directors.

The National Foreign Trade Council appreciates your invitation to present its views on H.R. 13103 at these hearings.

The National Foreign Trade Council has been engaged for 53 years in the promotion and protection of American foreign trade and investment and therefore in recent years has been vitally concerned with the need to remedy the recurring deficits in the balance of payments of the United States. Consequently, the recommendations of the Fowler task force were welcomed as a step to end the imbalance by attracting foreign investment in U.S. securities. Implementing these recommendations could be an important factor in eliminating the deficit in our payments position and a significant move toward achieving the ultimate objective of greater freedom of international movement of capital.

The council and its highly diversified membership considered the introduction last year of H.R. 5916 to implement the tax part of the Fowler Committee recommendations to be a most important forward step. The council favored the provisions of H.R. 5916 for encouragement of foreign investment in the United States and recommended its enactment with certain modifications. However, the introduction of H.R. 11297 and H.R. 13103, in turn, as substitutes for H.R. 5916 has presented matters of grave concern to the council. H.R. 13103, as now pending, has changed the original provisions of H.R. 5916 with regard to income and estate taxes on foreign corporations and nonresident aliens, and is less favorable in this respect than the original bill—H.R. 5916.

Furthermore, there has been embodied in H.R. 13103 an objective which is in direct conflict with the purposes of the Fowler report; that is, a general revision and broadening of U.S. taxation of nonresident aliens and foreign corporations which would be treated as "effectively connected" with an office in the United States. The council believes that the adoption of this new taxing system would be unwise and inequitable; that rather than raise additional revenue it would lead foreign corporations to reduce their investment and employment in the United States; that it would come into conflict with the prevailing pattern of taxation of international business by the principal trading nations of the world; and that it would produce serious problems of double taxation. Moreover, in our estimation, the enactment of these provisions would adversely affect the U.S. balance of payments not only from reduction in business investment but also from the foreseeable liquidation of foreign holdings of American short-term obligations and the liquidation of bank deposits of foreigners. The council has grave concern over the inclusion in the bill of these provisions which represent a radical departure from the objective of the original bill, and which the council considers would defeat the very purposes of the Fowler committee's recommendations.

The council, through its tax committee, has given thorough consideration to H.R. 13103 and has prepared a detailed statement based upon the results of their deliberations. Copies of this statement have been filed with your committee. It is requested that it be made a part of the record of these hearings and that full consideration be given to the views of the council, particularly because of the importance of this legislation as it may affect the international balance-of-payments position of the United States.

Senator ANDERSON. Is this the document?

Mr. NORRIS. Yes.

Senator ANDERSON. It will be placed in the record.

Mr. NORRIS. In summary, then, Senator, the council's principal reservations with respect to this legislation are:

(1) Concern about the possible adverse effect of this legislation on international trade and commerce through the introduction of the "effectively connected" concept relating to taxation of foreign enterprises; and

(2) The adverse effect to which I have alluded—and the filed statement more fully covers the subject—that certain portions of this legislation would have on the balance-of-payments position of the United States.

I would merely like to conclude by saying that there have been introduced two additional amendments in the Secretary's statement this morning, and also the report of the joint staff, and we would like the opportunity, obviously, to examine these, and to have the opportunity to present our views if they are indicated at the future time.

Senator ANDERSON. We certainly will, Mr. Norris. You take those with you, and if you have comments, send them to the committee as soon as possible because I understand we will be working on this bill within the next week or 10 days.

Mr. NORRIS. Thank you.

Senator ANDERSON. Thank you. I am sorry the other members of the committee have gone, but I appreciate your coming very much.

Mr. NORRIS. Thank you.

(The pamphlet referred to above follows:)

STATEMENT

Of The

NATIONAL FOREIGN TRADE COUNCIL, INC.

With Respect To

H.R. 13103

FOREIGN INVESTORS TAX ACT OF 1966

Presented to the Committee on Finance
of the United States Senate
August 8, 1966

NATIONAL FOREIGN TRADE COUNCIL, INC.
10 Rockefeller Plaza, New York, N. Y. 10020

SUMMARY

A. Effectively Connected Concept.

1. *Foreign Source Income.* — The purposes stated by the Report of the Ways and Means Committee for taxing specified rents and royalties, specified dividends, interest, and gains, and certain income from sales of goods made through a U.S. office, if "effectively connected" with the conduct of a trade or business in the U.S., are to prevent the use of the U.S. as a "tax haven" with respect to certain types of transactions and to impose tax on "income generated from U.S. business activities."

2. *"Tax Haven" Purpose.* — This purpose appears to be specious in that (1) the scope of the bill goes beyond "tax haven" situations; (2) any abuses which exist could more appropriately be corrected by other countries; and (3) legislation by the U.S. would only drive the activities affected to countries which impose no taxes.

3. *Purpose of Taxing "Income Generated from U.S. Business Activities".* — The bill would change the U.S. method of taxing the income of foreign corporations from one which meshes well into the established international system which has been developed in the income tax laws of the principal trading nations into one which would conflict with that system and create unwarranted double taxation. Income tax laws of most countries do not seek to tax income from sources outside their borders merely because of incidental and ancillary activities within their borders. It still is in the self-interest of the U.S. to adhere to this generally recognized principle. Taxation based on the "effectively connected" concept would tend to discourage purchasing within the country and would prompt the removal of offices which now furnish investment and employment in the country.

The bill applies the "effectively connected" concept in a one-sided manner, and does not recognize the right of other countries to apply a similar rule, in that it does not permit U.S.-source income of foreign corporations to be exempt to the extent that foreign offices and activities help to generate the income and does not even modify the limitations on U.S. foreign tax credits so as to allow credit for foreign taxes imposed on U.S.-source income "effectively connected" with foreign business activities.

4. *Conflict with U.S. Tax Treaties.* — The bill would come into conflict with most, if not all, of the existing tax treaties to which the U.S. is a party. Some treaties prohibit the taxation of foreign source income as attributable to a U.S. office; two of the recently proposed treaties expressly embody our existing source rules. Others limit such taxation to cases where the office qualifies as a permanent establishment and then limit the amount

of income which can be taxed to that which the activities would have earned if carried on by an independent corporation. The bill does not conform to these rules.

5. *Effect on Controlled Foreign Corporations.* — Congress in 1962 reviewed the "tax haven" possibilities of U.S.-controlled foreign corporations and enacted subpart F of the Code, prescribing the types of income of such corporations which should be taxed immediately and deferring taxation of other classes of income until remitted to the shareholders. The bill would impose immediate U.S. tax on income as to which the policy of subpart F was to continue deferment. It is believed that consistency with the policy of subpart F should be maintained by making the new provisions inapplicable to income of controlled foreign corporations which were excluded from subpart F.

6. *Income of Banking and Similar Corporations.* — The bill exempts dividends and interest from foreign sources, received by a foreign corporation from corporations in which it has a 50% stock interest. It is suggested that a 10% stock ownership requirement would be more appropriate.

7. *Sales to Foreign Customers.* — The bill would not tax income from sales for use, consumption, or disposition outside of the U.S., even though the income would otherwise be "effectively connected" with a U.S. office, "if an office or other place of business of the taxpayer outside the U.S. participated materially in such sale." The Council is concerned that this language will not be construed to give proper recognition to foreign activities other than selling—for example, manufacture, extraction, or production of goods and purchasing and related activities.

8. *Sales to Foreign Customers of U.S. Exports.* — It is not believed that the U.S. should seek to tax any income of foreign corporations from sales outside the U.S. to foreign customers of goods purchased in the U.S., nor to tax more than the profit attributable to manufacture or production on such foreign sales of goods manufactured or produced here. Such taxation would run counter to our national policy of encouraging exports.

9. *Sales to U.S. Customers.* — In the case of foreign source income from sales to U.S. customers, it should be made clear that the income deemed to be "effectively connected" with a U.S. office will not exceed that which would be allocable to that office if its activities had been carried on by a separate subsidiary of the foreign corporation.

10. *Foreign Sales with No Foreign Office.* — Where a foreign corporation has substantial foreign economic activities outside the U.S. but no office outside the U.S., the foreign source income deemed to be "effectively connected" with its U.S. office should be limited as suggested in paragraph 9 above.

11. *Credit for Foreign Income Taxes.* — Foreign corporations would suffer serious double taxation with respect to income "effectively con-

nected" with a U.S. office, because of failure of the bill to allow a credit against the U.S. tax for all foreign taxes imposed on the "effectively connected" income. Such credit should be given regardless of whether the taxing country is the country of source, the country of domicile, or both.

12. *Rental and Royalty Income.* — The bill appears to go much further in attributing rental or royalty income to U.S. offices than it does in the case of sales income, since it does not seem to give recognition to the activities of foreign offices in negotiating and making leases or licenses. It also seems unrealistic to regard royalties paid for the use of a valuable right as being generated entirely by the making of the contract. It is the making of the invention or its use in manufacturing which should be considered to generate the income.

13. *Section 245.* — Under the bill, 15% of any dividends paid by a foreign corporation, out of its "effectively connected" foreign source income, to a U.S. corporate shareholder, would be subject to U.S. tax if 50% or more of the foreign corporation's gross income was "effectively connected" with its U.S. trade or business. However, no foreign tax credits would be allowed to reduce the U.S. income tax on such dividends. It is not believed that the bill should introduce double taxation in this situation.

B. Balance of Payments Considerations.

1. *U.S. Estate Tax.* — The bill gives some reduction in estate tax rates on estates of nonresident aliens, but does not give as great a reduction as was proposed in H.R. 5916, the original bill introduced to implement the Fowler Report.

By including certain classes of intangible property which is excluded from the taxable estate under present law, the bill would have an adverse effect on foreign investment in the U.S.

2. *Interest on U.S. Bank Deposits.* — The bill proposes to terminate, effective at the end of 1971, the long-standing exemption of interest on bank deposits paid to nonresident aliens and foreign corporations, even though the recipient is not engaged in trade or business in the U.S. It is believed that this change will not actually produce additional revenue but that it will rather cause withdrawal of such deposits from the U.S., with a substantial adverse effect on our balance of payments.

3. *Short-Term Promissory Notes.* — Proposed section 881(a)(3) would tax foreign corporations not engaged in trade or business in the U.S. on amounts of original issue discount which are treated as ordinary income received on retirement or sale or exchange of bonds or other evidences of indebtedness issued after September 28, 1965 if held for more than six months. To subject such discount to U.S. income tax will cause foreign corporations not engaged in trade or business in the U.S. to cease to furnish a market for commercial paper, especially since it is feared by

some that the new provision may be construed to apply whether or not such commercial paper is held for more than six months. The annual market for short-term (9 months and under) commercial paper sold in the U.S. to nonresidents is estimated to be in excess of $1 billion. The loss of this market would have a severe adverse effect on our balance of payments.

4. *Section 904(f).*—The bill would make the special limitation on foreign tax credits with respect to interest income inapplicable to interest income received by an "overseas operations funding subsidiary" on obligations of a "related foreign corporation." The Council supports the general purpose of this amendment, although it believes the exception in existing 904(f) (2) (C) should be construed to apply where a U.S. parent uses a domestic affiliate to finance the operations of a foreign affiliate owned by such domestic parent to the extent of at least 10%, whether such ownership is direct or indirect.

The proposed definition of the terms "overseas operations funding subsidiary" and "related foreign corporation" contained in the bill are unduly restrictive, and should be liberalized. The Council urges that section 904 (f) (2) (C) be clarified so as to exclude interest received from a corporation in which the recipient (or another member of the same affiliated group, as defined in section 1504) owns directly or indirectly 10% or more of the total combined voting power of all classes of stock.

The present law also contains an exception of interest on obligations acquired on disposition of stock or obligations of a corporation in which the taxpayer owns at least 10%. This should be extended to obligations acquired as a result of disposition of stock of a wholly-owned subsidiary of such a 10% owned corporation.

CONTENTS

INTRODUCTION

In October of 1963 the President appointed a Task Force on "Promoting Increased Foreign Investment in U.S. Corporate Securities and Increased Foreign Financing for U.S. Corporations Operating Abroad" (Fowler Committee) to stimulate investments in the United States by foreigners. The increased inflow of investment funds from abroad would have an immediately favorable effect on reducing the pressure on the U.S. balance of payments. For this reason the Council welcomed H.R. 5916 which was proposed by the Treasury Department to carry out several of the Fowler Committee recommendations. However, as stated in its Report on H.R. 13103, the House Committee on Ways and Means has modified considerably the objectives of the earlier bill. On Page 6 the Report states: "While . . . the initial bill proposed by the Treasury Department was designed primarily to stimulate investments by foreigners in the United States, your Committee considered more generally the tax provisions of present law affecting nonresident aliens and foreign corporations."

For equity reasons and because of the potential adverse effect on our balance of payments position the Council is deeply concerned over a number of provisions in the bill as presently drafted. These provisions include those relating to:

1) the taxation of foreign source income of foreign corporations under the "effectively connected" concept;

2) the inclusion of the U.S. bank deposits and U.S. debt obligations in the taxable estate of a nonresident alien;

3) the taxation of interest on bank deposits received after 1971 by nonresident aliens and foreign corporations even though not "effectively connected" with the conduct of a trade or business in the U.S.;

4) the taxation of certain evidences of indebtedness described in proposed sections 871 (a) (i) and 881 (a) (3);

5) the overly restrictive application of the provisions relating to the treatment of interest received by an "overseas operations funding subsidiary."

There follows a detailed presentation of these five areas of concern.

EFFECTIVELY CONNECTED CONCEPT

Foreign Source Income

H.R. 13103 as passed by the House of Representatives would amend the Internal Revenue Code to broaden the present rules for U.S. taxation of foreign corporations to include not only income from sources within the United States but also certain types of foreign source income "effectively connected" with the conduct of a trade or business in the United States. These are:

(i) Rents and royalties derived from the active conduct of a licensing business;

(ii) Dividends, interest, or gain from stock or bond or debt obligations derived in the active conduct of a banking, financing, or similar business; and

(iii) Certain income from sales of goods made through a U.S. office.

The purpose of this feature of the bill is described in the Ways and Means Committee's Report primarily as prevention of the use of the United States as a "tax haven" with respect to certain types of transactions which might escape tax in other countries if certain activities are carried on in the United States. The Report states further (at P. 15) that "it is believed that foreign corporations should pay a U.S. tax on the income generated from U.S. business activities."

"Tax Haven" Purpose

The National Foreign Trade Council believes that the "tax haven" aspect of these purposes is specious in that: (a) any abuses which exist could more appropriately be corrected by other countries; (b) the scope of the bill goes beyond "tax haven" situations; and (c) legislation by the United States would only drive the activities affected to countries which impose no taxes.

The Report of the Ways and Means Committee describes the "tax haven" purpose as relating to cases in which international sales, licensing and financial activities can be carried on with an office in the United States without payment of income taxes to any country because (1) the foreign corporation is organized in a country which does not tax its corporations on income derived from the conduct of business outside the country; (2) the income may not be taxed where the goods are sold because the corporation does not have a permanent establishment there; and (3) the United States will not tax the income because under United States rules the income is not derived from sources within the United States. The Report does not state how widely this triple combination of circumstances has been found to exist.

The Council does not believe that the elimination of the alleged abuses is properly a matter for legislative action by the United States. The examples cited in the House Committee report could more appropriately be corrected by changes in the tax laws of other countries. Thus, the country of incorporation could adopt the long-standing U.S. practice of taxing locally-organized corporations on their world-wide income. Alternatively, the country in which the sale is made could logically impose a tax on the transaction. Finally, the country where the controlling shareholders reside could impose tax under provisions similar to subpart F enacted as a part of the U.S. Revenue Act of 1962. However, the failure of these countries to act does not furnish a sound reason for the United States to reach out and tax income more properly within the jurisdiction of other countries.

The fallacy of the "tax haven" purpose of the bill is indicated by the fact that its application would not be limited to cases in which income is escaping taxation by other countries. In fact, the question of whether some other country taxes the income would be given no effect in determining whether the new U.S. tax would apply.

The only cases in which income of the three specified types, treated as "attributable" to a United States office, would not be taxed under the bill are those in which goods are sold for use outside of the United States and there is also a foreign office participating materially in the sale. However, no exceptions whatever are recognized with respect to "effectively connected" income from licensing operations, dividends and interest, or income from sales of goods for use in the United States.

It is probable that in most cases the foreign source income which the bill subjects to United States tax will be taxed by the country of source of the income or the country of incorporation. The bill not only applies in these non-tax haven situations; it would not even give a foreign tax credit for a tax imposed by the country of incorporation unless it was also the source of the income and then not in all such cases.[1] Even when credit is given for a tax imposed by the country of source of the income, the bill may still have the effect of imposing a residual U.S. tax on foreign source income in a non-tax haven situation.

Even if the bill is enacted, the "tax haven" purpose will not be accomplished, since the U.S. offices whose activities will be considered to generate United States taxable income can be removed to genuine "tax haven" countries which would impose no income taxes. Thus the bill would accomplish neither elimination of international tax avoidance nor an

[1] Because of ill-chosen phraseology, the proposed statute may fail to allow a credit where the country imposing the foreign income tax is both the country of "source" and the country of domicile, unless a similar tax would have been imposed by that country if the corporation had been domiciled in another country.

increase in the United States revenues. It would simply cause the United States economy and balance of payments to lose the benefit of the employment and expenditures of United States offices of foreign corporations.

It is therefore apparent that, although H.R. 13103 uses the same "tax haven" label as a subpart F, its real thrust is in the opposite direction, i.e., to discourage foreign corporations from conducting activities within the United States rather than to discourage U.S. taxpayers from conducting activities in foreign countries.

The foreign corporations that would be affected by H.R. 13103 are not used to siphon off capital or employment from the United States. On the contrary, the use by such corporations of a U.S. office tends to augment both capital and employment in the United States.

Purpose of Taxing "Income Generated from U.S. Business Activities"

On first impression it seems difficult to disagree with the statement that there should be a U.S. tax on the "income generated from U.S. business activities" conducted through an office located within the United States. However, on analysis, it will be seen that the real issue is as to what income is "generated" from U.S. activities.

The bill as drafted would change the United States method of taxation of the income of foreign corporations from one which meshes well into the established international system which has been developed in the income tax laws of the principal trading nations into one which would conflict with that system and create unwarranted double taxation. It would detract from the degree of international harmony which now exists as to rules of source of income and provisions for foreign tax credits.

Under existing tax systems, including the U.S. system, income of the types affected by the bill is generally treated as entirely taxable by a single country which is regarded as the source of the income. A country other than the country of source does not seek to tax a portion of the income simply because that portion might be regarded as "generated" by activities within its borders. General recognition of this principle is necessary to avert the double taxation that results from conflict between the laws of different countries.

The income tax laws of most countries apply to income attributable to local manufacture and production of commodities. Income from selling is usually attributed by existing tax systems entirely to a single country, i.e., the place of title passage or the place of contract. Income from licensing intangibles is generally considered to have its source in the country where the right is exercised or, under recent treaties, the domicile of the owner. Similarly, dividend or interest income is generally attributed to the situs of the payor or the source of the payor's income, except for some treaties which attribute it to the domicile of the owner of the shares of stock or the debt claim.

There are many reasons why governments should abstain from basing income taxes on incidental and ancillary activities occurring within their borders. For example, this policy prevents the taxation of a portion of income derived from foreign selling of goods which are purchased in the country, even though, from the "activity" point of view, the purchasing side of the business may be more substantial than the selling side of the business in terms of assets, personnel and skills devoted to it. Most governments understand that it would not be in their own interest to attempt to levy income taxes which would burden the purchase of their products. As to local offices in charge of other ancillary activities such as warehousing, transportation, and technical assistance to suppliers in the country, and even offices for solicitation and negotiation of sales, governments generally understand that such offices could readily be removed, if threatened with the burden of a tax on the income from sales. This is also true as to local offices engaged in the licensing of patents and other intangibles.

It is still in the self-interest of the United States to adhere to the generally recognized principle of not trying to derive revenue from offices and activities which are likely to be driven away rather than to pay tax.

In addition, in the case of income from the licensing of such intangibles, the bill is particularly unrealistic in attributing the income to the activity of negotiating and concluding license contracts rather than to the ownership of the intangible or its actual use in operations.

Substantial double taxation would also result from the imposition of the proposed tax by the United States on foreign source income "effectively connected" with a U.S. office. The situation would be chaotic if other countries also adopted a similar rule, unless entirely new apportionment formulas were consistently applied by all countries. It seems unlikely that international tax consistency could be re-established until after years of international negotiations, if ever.

As a generally accepted international rule, an "activities" test could work satisfactorily only as a *substitute* for existing source rules. In the case of the United States, the bill does not propose such substitution. It uses the "activities" test to impose U.S. tax on income which is not now taxable under the existing source rules, but it does not permit the "activities" test to excuse from U.S. tax any U.S.-source income "effectively connected" with a foreign office.

Moreover, the bill would thus tax a foreign corporation on U.S. source income generated by foreign business activities without, in most cases, giving a credit against the U.S. tax for the foreign tax on such U.S. source income.

The bill also ignores the corollary of its stated purpose, i.e., that a foreign country would then be entitled to tax a U.S. domestic corporation on its U.S. source income "effectively connected" with an office located within the foreign country. The bill ignores this situation since it fails to modify the existing limitations under section 904 which would normally disallow any U.S. credit for foreign taxes levied on U.S. source income.

To summarize, the bill treats its new "activities" test as taking precedence over the existing source rules when the activities occur within the United States but not when the activities occur within a foreign country. This inconsistency is compounded by the bill's adherence, in determining the limitation on U.S. credits for foreign taxes, to existing source rules instead of using its new "activities" test to attribute income to a foreign country.

The Council therefore submits that, if the purpose of the bill is to set a precedent for a reform of tax laws throughout the world, the bill should at least apply its new "activities" test in an even-handed manner, which might work if other countries were to follow this new concept, rather than on a one-sided basis which could only produce numerous cases of double taxation if other countries followed the lead of the United States. If the activities test as contained in the bill is not valid as a precedent ~~for~~ for other countries, the United States is not justified in adopting it.

Conflict with U.S. Tax Treaties

The United States has concluded numerous tax treaties which prohibit the taxation, as attributable to a United States office, of income from sources outside the United States. (Significantly, two of the most recently proposed treaties—with Israel and Thailand—specifically set forth our existing source rules for this purpose).

It is true that other U.S. tax treaties do not expressly prohibit U.S. taxation of foreign source income attributable to an office in the United States, if that office qualifies as a "permanent establishment". But even those treaties expressly limit the amount of income which could be so attributed to the amount which the particular activities would earn if carried on by an independent corporation with no other activities. The bill, in contrast, would apply in many cases where there was no such permanent establishment and is ambiguous as to whether the amount of income which would be attributed to the U.S. office of the foreign corporation is limited to only the amount fairly allocable to the U.S. activities.

The bill thus would come in conflict with most, if not all, of the existing tax treaties to which the United States is a party. While the proposed section 894 makes the bill inoperative to that extent, it nevertheless seems fair to question the need either (1) to renegotiate these numerous treaties or (2) to discriminate against foreign corporations belonging to the many non-treaty countries of the world, which include most of the "less developed countries." These unfortunate alternatives would seem to be justified only by some inherently desirable and necessary policy.

We submit that no such policy is furnished either: (1) by the idea that the United States is entitled to move into any vacuum created by supposed loopholes in foreign tax laws, or (2) by the idea that all income should be fragmented into as many pieces as there are countries in which some "activities" are performed. Much less does it seem a tenable position that the United States alone is entitled to apply these ideas, the universal application of which could only result in years of conflict between the tax systems of the nations of the world.

Effect on Controlled Foreign Corporations

The new provisions of H.R. 13103 would be particularly objectionable in their application to foreign corporations controlled by U.S. persons.

In enacting the Revenue Act of 1962, the Congress conducted an extensive review of the "tax haven" possibilities of such controlled foreign corporations. Subpart F of the 1962 Act reflects the decision of Congress to tax certain types of income immediately and to allow the taxation of certain other classes of income to be deferred until such income is remitted to the shareholders. It would appear that the exclusion of all income of controlled foreign corporations would be appropriate since Congress has carefully prescribed just what income of such controlled foreign corporations should be currently taxed.

It should also be noted that various classes of income are excluded from immediate taxation under subpart F, including:

1) Dividends, interest and gains realized by a corporation engaged in a banking, financing or similar business:
2) Dividends, interest and gains from qualified investments in less developed countries:
3) Income which would otherwise be subpart F income but which constitutes less than 30% of the foreign corporation's gross income:
4) Income of a foreign corporation not availed of to reduce taxes:
5) Royalty income derived in the active conduct of a trade or business which is received from unrelated persons.

H.R. 13103 would in some cases impose an immediate U.S. tax on the above classes of income and thus appears inconsistent with the policies excluding those classes of income under subpart F. The Council believes that consistency with those policies would require a similar exemption of such classes of income from tax under H.R. 13103.

The exclusion of such classes of income of controlled foreign corporations from coverage under the bill would not be a discrimination in favor of U.S. controlled corporations because such exclusion would only mitigate the existing discrimination against U.S. controlled foreign corporations created by subpart F.

Income of Banking and Similar Corporations

The provisions of H.R. 13103 for taxing dividends and interest received by foreign corporations engaged in banking, financing or similar business would exempt dividends and interest received by such corporations from corporations in which they have a stock ownership of more than 50%. A 10% ownership requirement would be consistent with the stock ownership requirement for qualified investments in less developed countries and with the realities of present-day foreign investment. Many countries do not permit 50% foreign ownership, and such a high percentage of foreign ownership would tend to discourage participation by local investors in necessary industries.

It is noted that the bill does not define what is meant by "banking, financing, or similar business." Presumably this provision is intended to be correlated with the provision in section 954 (c) (3) (B).

Sales to Foreign Customers

If the foreign corporation maintains an office in the United States and a second office outside the United States, the proposed statute would exempt from U.S. tax the entire profit from the sale of goods arranged through the U.S. office "if the property is sold for use, consumption or disposition outside the United States and an office or other place of business of the taxpayer outside the United States participated materially in such sale."

The Report of the Ways and Means Committee indicates (at P. 16) that the purpose of the phrase "participated materially in such sale" is to assure that "foreign source sales income will be attributed to the U.S. trade or business only when the U.S. office is the primary place of the activity giving rise to the income."

The Council is concerned that the proposed statute will not be interpreted to effectuate this purpose. This concern stems primarily from the ambiguity of the word "sale" as it is used in the phrase "office or other fixed place of business of the taxpayer outside the United States participated materially in such sale."

One possible interpretation is that the term "sale" refers solely to selling activities. Under this interpretation, a foreign office or other place of business would be considered to have "participated materially in such sale" only if its activities were selling activities as contrasted with the performance of other economic activities essential to earn the ultimate profit, such as the manufacture, extraction, or production of the goods or their procurement by purchasing activities.

The practical effect of this restrictive interpretation can be illustrated by the case of a Philippine corporation engaged in the business of purchasing hand-embroidered household linens, blouses, etc., for export to overseas customers. The Philippine corporation maintains its principal office in Manila, where a staff of employees places orders with numerous small Philippine factories to which the corporation furnishes technical and stylistic advice as well as working capital. The Philippine corporation takes title to the goods at the factory and arranges for temporary warehousing, insurance, transportation to the dock, and all of the formalities required for exportation. Sales to customers in Canada as well as the United States are negotiated by a single employee working from a sales office maintained by the Philippine corporation in Seattle, Washington. Title to the merchandise normally passes to the customer at the time of shipment from Manila, so that none of the resultant profit is from a "source" within the United States.

Under these facts, the Philippine corporation is clearly subject to whatever income taxes the Philippine Government may see fit to impose. (Moreover, Philippine tax would also be imposed if the above described business were conducted by a Philippine branch of a Panamanian corporation.) Thus, this case cannot properly be considered to involve the type of "tax avoidance" at which H.R. 13103 is said to be aimed.

The Council therefore submits that the office in Manila should be considered as having "participated materially in [the] sale" of the goods sold through the Seattle office, so that the tax imposed by H.R. 13103 would not apply to profits from those sales made to Canadian customers.[2] This interpretation of "sale" would be essential to carry out the stated objective of the Ways and Means Committee that "foreign source sales income will be attributed to the U.S. trade or business only when the U.S. office is the primary place of the activity giving rise to the income."

In support of this position, it should be pointed out that, under the House version of H.R. 13103, it is clear that, where a foreign office of a foreign corporation participates materially in the selling activities, no U.S. tax would then be imposed on any profits from sales to foreign customers negotiated through its U.S. office.[3] If selling activities by a foreign

---

[2] This hypothetical example also serves to highlight the fact that H.R. 13103 could not impose U.S. tax on foreign source income of a Philippine corporation without renegotiation of the Income Tax Convention with the Philippines. Article 3(1) of that Convention (as submitted to the Senate on July 29, 1965) provides, in effect, that the United States may tax a Philippine corporation only on income derived from "sources" within the United States. As previously noted, however, H.R. 13103 does not recharacterize income "effectively connected" with a U.S. office as income having its "source" within the United States. On the contrary, it is clear from the proposed section 864 (c) (4) of the Code that no change in existing "source" rules is intended.

Enactment of H.R. 13103 would therefore have one of the two undesirable consequences: (1) it would require renegotiation of the Income Tax Convention with the Philippines and 17 other countries, i.e., Australia, Austria, Denmark, Finland, Greece, Honduras, India (proposed), Ireland, Israel (proposed), Italy, Japan, Luxembourg, New Zealand, Norway, Pakistan (proposed), Switzerland, Thailand (proposed), or (2) it would not apply to foreign corporations having their domicile or seat of management in the foregoing countries and thus would create a capricious discrimination in favor of those foreign corporations as distinguished from foreign corporations belonging to all of the other nations of the world.

[3] This is true both of goods exported from the United States and goods exported from one foreign country to another.

office furnish a valid reason for not imposing U.S. tax, it would be anomalous to impose U.S. tax where the activities of the foreign office (although not a sales office) are *more substantial* than those of the typical sales office, e.g., where the foreign activities are as extensive as the Philippine activities of the Philippine corporation described above.

It is believed that the foregoing analysis also leads to the conclusion that, where a foreign corporation engages in the manufacture, extraction, growth, or production of goods outside the United States, it should not be subject to any U.S. tax merely because it uses a U.S. office to arrange for sales of those goods to foreign customers.

It is clear, therefore, that an office or other place of business outside the United States should be considered to have "participated materially in the sale" of goods in all cases where those goods have been procured by substantial purchasing or productive activities conducted by the foreign corporation at its office or other place of business outside the United States.

U.S. Export Sales

Different policy considerations lead to a similar conclusion where the goods sold to foreign customers are either produced by the foreign corporation within the United States or purchased from suppliers within the United States. Here the imposition of any U.S. income tax by reason of selling activities of a U.S. office would clearly run counter to our national policy of encouraging U.S. exports, a policy essential to the strengthening of the U.S. balance of payments.

The Council believes that the selling of goods to foreign customers through a U.S. office should not give rise to any U.S. tax on the sale by a foreign corporation which either produces those goods within the United States or purchases them from suppliers within the United States. As under existing law, the sale of such goods, if produced by the foreign corporation, would give rise to U.S. tax on the portion of the total profit treated as U.S.-source income from production (as distinguished from selling) activities. (See Regulation 1.863-3(b)).

Sales to U.S. Customers

The bill fails to specify any method for determining the portion of the total profit taxable by the United States with respect to sales made through a U.S. office to customers located within the United States. Thus it may not give effect to the intention expressed in the Report of the Ways and Means Committee at P. 16:

> "In the case of foreign source income where the products are destined for the United States, the income will be treated as effectively connected with a U.S. business *to the extent* the sales activity is carried on by the U.S. office.

"The amount of income attributable to the U.S. sales office is not to be more than would have been attributable to it if the sale had been made in this country.[4] This gives assurance, for example, that the sales income attributable to a U.S. business will *not include income properly attributable to* manufacturing *or any other activities* (apart from sales) *occurring outside the United States."* (Emphasis added)

The general intention is clearly to exempt "income properly attributable to . . . activities . . . occurring outside the United States."

The Council is concerned, however, that the U.S. Treasury might try to tax the entire profit, without allocation, in cases where the foreign corporation imports into the United States goods which it has purchased (rather than manufactured, extracted, grown or produced) through an office or place of business maintained by it abroad, e.g., the case of the Philippine corporation using a Seattle office to sell hand-embroidered linens purchased through its extensive home-office facilities in the Philippines (described above).

This concern stems from an existing Regulation[5] which would, under present law, cause a foreign corporation to be taxable upon its entire profit from the purchase and sale, if it were to pass title to U.S. customers when the goods arrive in the United States rather than when the goods are shipped from the foreign country. This Regulation might lead the U.S. Treasury to argue that under H.R. 13103 the same amount, i.e., the entire profit, should be taxed in cases where title to the goods passes to the U.S. customer in the foreign country rather than in the United States.

It is submitted that any such interpretation would be unjustified: (a) on equitable grounds, (b) in view of the stated purposes of H.R. 13103, and (c) in view of the conflicting treaty obligations of the United States.

---

[4] This sentence appears to be directed to cases where the foreign corporation manufactures, extracts, or produces outside the United States the goods marketed to U.S. customers through its U.S. sales office. There the foreign corporation would pay U.S. tax under existing law on only an allocated part of its total profit from such sales if it were to pass title to the goods within the United States. (The method of allocation is described in Regulation Sec. 1.863-3(b)). Since H.R. 13103 would extend U.S. taxation to cases in which title to such U.S. imports passes outside the United States, the above-quoted sentence assures that the amount taxable under H.R. 13103 would not exceed the allocated part of the profit taxable under existing law where title passes within the United States.

[5] Regulation Sec. 1.861-7 provides:

"(a) General. Gains, profits, and income derived from the purchase and sale of personal property shall be treated as derived *entirely* from the country in which the property is sold. Thus, gross income from sources within the United States includes gains, profits, and income derived from the purchase of personal property without the United States and its sale within the United States." . . .

"(c) Country in which sold. For the purposes of part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder, a sale of personal property is consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer." (Emphasis added).

a. *Equitable Considerations*

It would be highly inequitable for the United States—solely because the selling activities of the single employee stationed at the Seattle office—to attempt to tax the entire profit of the Philippine corporation from sales to U.S. customers. Such taxation would be unfair because it would ignore the much larger volume of activities and assets having their situs in the Philippines.

The case of the Philippine corporation is very different from the type of case to which the existing Regulation is addressed. The latter may be illustrated by an English corporation operating a retail shoe store in New York where it sells shoes purchased from suppliers in England. Here title to the shoes necessarily passes to U.S. customers within the United States, causing the entire profit from their sale to be taxable by the United States. This result is reasonable because the English corporation's business is substantially similar to that of a U.S. domestic corporation selling shoes from an inventory maintained within the United States.

This type of business is very different, however, from the type of business to which H.R. 13103 is directed. Thus, the nature of the Philippine corporation's business does not require it to land and warehouse its goods within the United States. Accordingly, the fact that title to the goods passes to the U.S. customer when the goods are shipped from Manila (rather than when they arrive in Seattle) is no mere technicality. On the contrary, this fact flows from the nature of the business of the Philippine corporation: that its economic "center of gravity" is in the Philippines rather than in the United States. There is, therefore, no valid reason for the United States to tax the Philippine corporation *as if* it had been required by business exigencies to defer passing title to the goods until their arrival in Seattle.

b. *Objective of Ways and Means Committee*

U.S. taxation of the entire profit of the foreign corporation would also conflict with the stated objective of the Ways and Means Committee to tax "income generated by U.S. business activities." Clearly, the aim of taxing "income generated by U.S. business activities" does not justify the taxation of profit from other activities performed by a foreign corporation outside the United States.

As previously noted, the Report of the Ways and Means Committee is explicit "that the sales income attributable to a U.S. business will not include income attributable to manufacturing *or any other activities* (apart from sales) occurring outside the United States." (Emphasis added). This intention is stated even more emphatically at P. 64:

> ". . . if only a part of the income, gain, or loss from a transaction, or series of transactions, is properly considered attributable to such

office, or other fixed place of business within the United States, *only that part* shall be treated as effectively connected with the conduct of a trade or business within the United States." (Emphasis added)

While these statements of Congressional intent are helpful, it is believed there should be no possible ground for a contrary interpretation.

c. *U.S. Tax Treaty Commitments*

A fair apportionment of the foreign corporation's income is also required by many of the income tax treaties to which the United States is a party.

As indicated above under these treaties,[6] the U.S. is clearly barred from taxing the U.S. branch office of a foreign corporation (having its domicile or seat of management in the treaty country) on more than that portion of the profit arising from its U.S. activities "which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing at arm's length" with its home office in the treaty country.

It is submitted that the United States should not attempt to tax a greater amount to those foreign corporations belonging to countries having no such tax treaty with the United States. Most of the non-treaty countries are the "less developed countries" of Latin America, Africa and Asia. It is the policy of the United States to assist the economic development of these "less developed countries." Consistency with that policy would prohibit the United States from imposing more stringent taxes on those countries' corporations engaged in importing their products into the United States than on corporate importers belonging to treaty countries.

The Council believes that H.R. 13103 should provide that the amount of income of a foreign corporation attributable to sales to U.S. customers made through a U.S. office should not exceed the amount which would be allocable to that office if it had been maintained by a separate subsidiary corporation of the foreign corporation.

Foreign Sales With No Foreign Office

In addition, a similar allocation should be permitted with respect to sales by a foreign corporation, which has substantial economic activities outside the United States but no office outside the United States, of goods of foreign origin sold for use, consumption or disposition outside the United States. The corporation should not be subject to U.S. tax on its entire income from sales negotiated through its U.S. office if part of its income is economically attributable to other factors.

For example, the foreign corporation may purchase goods in one for-

[6] Provisions of this type appear, for example, in the U.S. Tax Treaties with Belgium, Germany, Netherlands, the United Kingdom, and South Africa.

eign country and transport them to another country for sale there. If part of its profit is fairly attributable to its transportation activities or other factors, it should be subject to U.S. tax only on the portion of its profit attributable to the selling functions performed at its U.S. office.

Credit For Foreign Income Taxes

A major defect of the House version of H.R. 13103 is its failure to provide adequate relief from international double taxation of income "effectively connected" with a U.S. office or other fixed place of business.

This problem may also be illustrated by the example (set forth above) of the Philippine corporation purchasing hand-embroidered linens in the Philippines and selling them through a U.S. office to both U.S. and Canadian customers.

In this typical case, the country of purchase (the Philippines) will impose its tax on the entire profit either: (i) because the corporation is domiciled or has its seat of management in that country or (ii) because the corporation passes title to the goods within the country of purchase. In addition, H.R. 13103 would cause the United States to tax the same profit.

The resultant double taxation should be alleviated by allowing the foreign corporation a credit against its U.S. tax for the foreign tax on the double-taxed income.

Under H.R. 13103, such a credit would be allowed, however, only where the foreign tax is imposed by the country in which the income has its "source", i.e., the country in which title to the goods passes,[7] but not where the foreign tax is imposed by the country in which the foreign corporation has its domicile or seat of management, i.e., by its home country.[8]

The apparent rationale of this distinction is that the right of the United States to tax income "effectively connected" with a U.S. office should take precedence over the right of the foreign corporation's home country to tax such income. Under this theory, double taxation would be averted by allowance by the home country of a credit against its tax for the U.S. tax (rather than by allowance by the United States of a credit against the U.S. tax for the home country's tax).

While this new theory may at first appear plausible, there are several reasons why it is not likely, in practice, to avert double taxation.

---

[7] As mentioned above, the proposed statute may fail to allow a credit where the country imposing the foreign income tax is both the country of "source" and the country of domicile, unless a similar tax would have been imposed by that country if the corporation had been domiciled in another country.

[8] Thus, for example, no credit would be allowed for the Philippine tax if the United States were to tax the Philippine corporation on sales to Canadian customers negotiated by its U.S. office and if those customers were to take title to the goods upon their arrival in Canada rather than upon their shipment from the Philippines. On those facts, credit would be denied because the foreign tax would be imposed by the country of domicile (the Philippines) rather than the country of "source" (Canada).

A serious practical objection is that some foreign countries, such as Sweden, tax their local corporations on world-wide income without allowing appropriate credits for taxes paid to other countries.

Moreover, even if the foreign corporation's home country does, in general, allow credit for income tax paid to other countries, it may well deny a credit in those cases where title to the goods passes at the point of shipment within the home country because the income would then have its "source" within that country (rather than within the United States where the sales office is located). Since the U.S. Treasury does not allow any credit to U.S. corporations for foreign taxes on domestic source income, how can it reasonably expect that foreign governments will allow credit to their corporations for a U.S. tax on *their* domestic source income?

Finally, the foreign corporation's home country may restrict the credit allowed to its local corporations for taxes paid to other countries by means of a "per-country limitation" similar to that under the U.S. tax law. Such a "per-country limitation" would often operate to eliminate the foreign country's credit for any U.S. tax imposed on profits from sales to foreign customers whenever the income would have its "source" in the customer's country, e.g., when title passes upon arrival of the goods.

It is therefore apparent that foreign corporations would frequently suffer serious double taxation with respect to income "effectively connected" with a U.S. office, if the United States were not to allow a credit against its tax for all foreign taxes imposed on such income, regardless of whether the taxing country is the country of "source", the country of domicile, or both.

In this connection, it is noted that H.R. 13103 would impose on foreign corporations a *greater* tax burden than is borne by domestic corporations. Since a domestic corporation is allowed a credit against its U.S. tax for foreign taxes on its income from sources outside the United States, a foreign corporation should, if taxed under H.R. 13103, likewise be allowed a credit against its U.S. tax for foreign taxes on its income from sources outside the United States (to the extent that such income is "effectively connected" with a U.S. office).

Even if the United States were to allow a credit for income tax imposed by the home country, the foreign corporation might still suffer a serious detriment from the new U.S. tax proposed by H.R. 13103. That is because the credit would automatically be reduced to reflect any income tax benefits which the home country may see fit to grant.

For example, the home country might well confer a variety of tax advantages on a local corporation engaged in activities promoting the expansion of local exports, e.g., construction of new warehouse facilities, by means of "tax holidays", deductions for reinvested profits, rapid depreciation, etc. The economic incentive afforded by these tax benefits would often be completely nullified by the concomitant increase in the

U.S. tax payable by the local corporation. The net result would be particularly harmful for corporations exporting goods from the many "less developed" areas which offer such tax incentives, e.g., Ireland, Peru, Puerto Rico, Southern Italy, Trinidad, etc.

These inadequacies of the credit approach thus furnish further support for the need: (1) to eliminate the proposed U.S. tax on profits from sales to foreign customers by foreign corporations conducting substantial operations through a local place of business in a foreign country, and (2) to restrict any U.S. tax on profits from sales to U.S. customers to the amount which an independent sales agent would earn by performing services similar to those performed by the U.S. branch office of the foreign corporation.

Rental and Royalty Income

The bill includes as one of the types of income from sources without the United States which will be treated as "effectively connected" income, if attributable to a U.S. office of a foreign corporation or nonresident alien individual, rents or royalties for the use of intangible property outside the United States. While the bill itself is silent as to the criteria to be used in determining whether such rents or royalties are to be attributed to a U.S. office, the Ways and Means Report indicates that the test is whether the lease or license is "made by or through" such office. This, in turn, is said to depend upon whether a U.S. office actively participates in soliciting, negotiating or performing other activities required to arrange the license. The place where the invention was developed is immaterial under this test.

The Council firmly believes that it is unrealistic to regard the royalties paid for the use of a valuable right as being generated entirely by the making of the contract. It is either the making of the invention or its use in manufacturing which generates the income; salesmanship or the mere negotiation of the lease or license is generally of minor importance.

If the approach of the proposed statute is to tax rental and royalty income merely because of the presence of negotiating or related activities in the United States, the Council believes that modification of the bill is necessary to bring the rental and royalty provision into line with analogous portions of the bill and to avoid substantial inequity.

As presently formulated, under the test indicated in the Ways and Means Report, rental or royalty income would be attributed to a U.S. office if activities (other than general supervision) incident to the lease or license are performed by or through such office, irrespective of the extent to which a foreign office also participates or where the activities are performed. Thus, for example, royalty income might conceivably be attributed to a U.S. office even though: (1) the intangible property being licensed was developed or acquired entirely outside the United States, (2) the license is negotiated principally by a foreign office, but a technician assigned to a U.S. office participates in the negotiations or the drafting of the license agreement, and (3) the negotiations or other activities performed by personnel assigned to a U.S. office are performed entirely outside the United States.

As discussed above (Sales to Foreign Customers) in the case of income from sales the approach of the Ways and Means Committee is to attribute foreign source income to a U.S. office only when the U.S. office is the primary place of the activity giving rise to the income. To effectuate this purpose, the proposed statute would exempt from U.S. tax the entire profit from sales arranged through a U.S. office if the property is sold for use, consumption or disposition abroad and an office or other place of business of the taxpayer outside the United States participated materially in the sale. This approach should be equally applicable to income from the leasing or licensing of intangible property for use outside the United States. Thus no U.S. tax should be imposed where an office or other place of business of the taxpayer outside the United States has "participated materially" with respect to the lease or license, either through solicitation, negotiation or other activities related to the making of the lease or license, or through productive or purchasing activities directed toward the creation or acquisition of the intangible property by the taxpayer.

Section 245

H.R. 13103 would amend section 245 to provide an 85% deduction for dividends received from a foreign corporation engaged in trade or business within the United States and having 50% or more of its gross income "effectively connected" with the U.S. trade or business. The deduction would be in proportion to the "effectively connected" income of the paying corporation.

The Council wishes to point out potential double taxation which can occur under the bill where a U.S. corporate shareholder receives a dividend from a foreign subsidiary which has been subject to U.S. tax on its "effectively connected" income.

The following situation should be considered:

> Assume a situation where a wholly-owned foreign subsidiary of a U.S. corporation has only foreign source income but is subject to U.S. income tax on 100% of its income as being "effectively connected" with a U.S. trade or business. Assume also that it pays foreign income tax at a rate greater than the U.S. income tax rate and that the foreign income tax is creditable under proposed section 906 against the subsidiary's U.S. tax.

Under the bill, 15% of every dollar of dividends from the foreign subsidiary would be subject to U.S. income tax. Such taxation is generally referred to as an "upstream dividend tax." No foreign tax credit would be permitted to the U.S. parent under the revised provisions of section

861 (a) (2) (B) since this section would treat dividends from such a foreign corporation as being U.S. source income. Therefore, the section 904 limitation on the foreign tax credit would prevent any available foreign tax credits from being used to reduce the U.S. income tax payable on the dividends. Under existing law, the parent's U.S. income tax on dividends from such a foreign corporation could be offset by available foreign tax credits. It is submitted that to the extent that 15% of such dividends would be subject to the U.S. income taxation under the bill, this would constitute double taxation.

It seems inconsistent with the purpose for which the changes regarding foreign source income which might be "effectively connected" were made to have this result. That is, such changes were intended to prevent tax avoidance by foreign corporations. The effect of this "upstream dividend tax" is to impose an additional tax on U.S. shareholders. The Committee Report submitted by the Committee on Ways and Means does not specifically recognize the possibility of creating an additional tax on U.S. shareholder corporations. It is hoped, therefore, that this is an unintended effect which the Senate will correct.

BALANCE OF PAYMENTS CONSIDERATIONS

U.S. Estate Tax

As compared with H.R. 5916, this bill would increase estate tax rates on estates of nonresident aliens to a maximum of 25%, thus giving less incentive for foreign investment in the United States than was given by H.R. 5916.

H.R. 13103 would include in the taxable estate of a nonresident alien certain intangible personal property which is excluded from the estate under present law. Such property includes: (a) bank deposits in the United States of a nonresident alien not engaged in business in the United States, and (b) debt obligations of a U.S. person (including a U.S. corporation), the United States, a State or political subdivision of a State, or the District of Columbia, even though such obligations are physically located abroad. There is no doubt that these provisions will have an adverse effect on foreign investment in the United States.

Interest on U.S. Bank Deposits

Since the Revenue Act of 1921, interest on deposits with persons carrying on the banking business paid to persons not engaged in trade or business within the United States has been treated as foreign source income and consequently not subject to U.S. income tax. In considering the merits of this exclusion from taxable income, the House Ways and Means Committee Report (67th Cong., 1st Sess.) indicated that "the loss of revenue which would result if this deduction were allowed would be relatively small in amount, while the exemption of such interest from taxation would be in keeping with the action of other countries and would encourage nonresident alien individuals and foreign corporations to transact financial business through institutions located in the United States." H.R. 13103 would completely change this long-standing rule of law in that interest paid on bank deposits in the United States to nonresident aliens and foreign corporations after December 31, 1971, will become subject to income tax even though the recipient may not be doing business in the United States. The technical change in source definitions made by the bill affecting bank interest during the interim period 1966 through 1971 is not objectionable since it is not less favorable than existing law in its treatment of U.S. bank interest paid to foreigners.

It is submitted that the factors prevailing in today's economy are even more compelling than in the 1920's in requiring that interest paid on U.S. bank deposits to nonresident alien individuals and foreign corporations not doing business in the U.S. continue to be exempt from U.S. taxation. The U.S. balance of payments problem would be made more acute

67-485 O - 66 - 7

if this interest were taxed since it seems reasonable to believe that a substantial part of the underlying deposits would be transferred to foreign banks. If this were to happen there would be an increased likelihood of these dollars shifting from private to public hands and then becoming a claim on our gold. In addition, it is evident there would be no gain in U.S. tax revenue but in fact a loss, since the shifting of these deposits to foreign banks not subject to U.S. taxation would reduce taxable income otherwise generated by U.S. banks on these deposits.

The House Committee on Ways and Means recognized in its Report that an alteration of this source rule might have a substantial adverse effect on our balance of payments. For this reason the Report indicates that the effective date of this change is being postponed until after 1971 at which time there will be an opportunity to reconsider the balance of payments situation.

For the reasons noted above, the Council is in complete agreement that the proposed change in the source of income rules can have a substantial adverse effect on our balance of payments and that they should not be changed in the context of our present balance of payments difficulties. Indeed, the Council believes that the proposed change would be contrary to the best interest of the United States as a world financial center even in the absence of a balance of payments problem.

Furthermore, the Council does not believe that the present Congress should insert in the law a future date on which the long-standing exemption from tax will be automatically terminated, in view of its recognition that such termination can have serious economic consequences. It would seem that sound legislative procedure dictates that if this exemption is to be terminated at all, despite the continued validity of the reasons for which it was made a part of our law by the Revenue Act of 1921, it should be terminated by positive action of the Congress at the time of termination only after giving thorough consideration to the effect of the change in the light of the then current economic conditions; a situation should not be legislated by the present Congress under which a change in tax law having potentially serious economic consequences can become effective in 1972 by a combination of mere passage of time and inaction on the part of a future Congress.

Moreover, the Council believes that insertion in the law of a termination date for the present exemption will inadvertently negate at least in part the obvious intention of the Congress to reconsider the balance of payments situation *before* withdrawal of foreign-owned deposits from financial institutions in the United States is induced by taxation of the interest on such deposits. The existence of this date in the law will create a psychological barrier to further deposits and induce withdrawal of existing deposits even before the effective date of the tax, thus having a potential adverse balance of payments effect prior to essential Congressional reconsideration of the situation. Accordingly, the Council strongly urges that this date be deleted from the bill.

The Council agrees that foreign-owned funds on deposit with savings and loan associations and insurance companies should receive similar treatment to that given to bank deposits in the United States.

Short-Term Promissory Notes

Section 881 of the Internal Revenue Code imposes a tax on fixed or determinable income from sources within the United States of foreign corporations not engaged in the conduct of a trade or business within the United States.

Presently, section 881, in addition to taxing fixed or determinable income, imposes a tax on types of income described in section 631 (b) and (c), which relate to gains on the disposal of timber, coal and iron with a retained economic interest. Except as provided in section 631, foreign corporations not engaged in trade or business in the United States are not presently subject to tax on capital gains from United States sources. The Committee on Ways and Means in House Report No. 1450, Page 87, recognized this when it said:

> "Gains from the sale or exchange of a capital asset (other than amounts to which amended sec. 881 (a) (2) and (3) applies) are subject to tax only if they are received by a foreign corporation which is engaged in trade or business within the United States at some time during the taxable year for which the tax is being determined and are effectively connected with the conduct of a trade or business within the United States."

The proposed amendment to section 881 retains the types of income specified under present law as being taxable, but with two additions: (1) gains with respect to the sale of stock of a collapsible corporation, treated as ordinary income (section 341), and (2) amounts of original issue discount which are treated as ordinary income received on retirement or sale or exchange or bonds or other evidences of indebtedness issued after September 28, 1965 (section 1232).

Certain United States corporations, principally finance companies, in the ordinary course of business sell to nonresident aliens short-term (nine months and under) promissory notes (commercial paper) issued in bearer form at a discount without interest. With regard to these sales, the discount on the non-interest bearings notes has, under Revenue Rulings L. O. 1024, 2 CV 189 (1920); I. T. 1398, I-2 CB 149 (1922); I. T. 3889, 1948-1 CB 78 (1948), been considered to be not fixed or determinable and, therefore, not subject to tax. To subject such discount to Federal income tax will, as explained below, have substantial and lasting adverse effect on the United States balance of payments.

Proposed section 881 (a) (3), by reference to section 1232, specifically taxes income which, under section 1232, is treated as a gain from the sale or exchange of property not considered to be a capital asset and to the extent the amount received is not effectively connected with the conduct of a trade or business within the United States. Under section 1232, any gain realized to the extent of original issue discount from evidences of indebtedness held by the taxpayer more than six months is considered as gain from the sale or exchange of property which is not a capital asset.

Thus, by including a reference to section 1232, proposed section 881 would, in effect, be taxing a nonresident alien corporation on a gain from the sale or exchange of a capital asset which is not effectively connected with the conduct of business in the United States.

It is the Council's understanding that certain nonresident alien corporations which have in the past purchased substantial amounts of such commercial paper fear that the U.S. Treasury might interpret erroneously the proposed section 881 (a) (3) to the effect that the discount on all commercial paper sold to nonresident alien corporations will be taxable, without regard to whether or not such paper is held for more than six months. Thus, if the proposed section 881 (a) (3) is enacted, such corporations will cease to furnish a market for commercial paper. This would have a severe, adverse effect on the United States balance of payments. It is estimated that the annual market in this short-term (nine months and under) commercial paper sold in the United States to nonresidents is in excess of $1 billion. The possibility that the gain on this short-term paper might be subject to United States income tax will result in the permanent loss of a substantial part of such investment in the United States by nonresident foreign corporations. The Council believes the proposed section 881 (a) (3) should not be enacted.

Section 904 (f)

H.R. 13103 proposes to amend section 904 (f) of the Internal Revenue Code by making the present separate "per country" limitation with respect to interest income inapplicable to interest received by an "overseas operations funding subsidiary" on obligations of a "related foreign corporation."

While the Council supports the general purpose of the proposed amendment (set forth in the Report of the Ways and Means Committee at pages 39-40), it wishes to first point out that it believes that the exception in section 904 (f) (2) (C) of the present law should be construed to apply where a U.S. parent uses a domestic affiliate to borrow foreign funds to finance the operations of its (the parent's) foreign subsidiary, despite the doubt expressed on this point on page 40 of the Committee Report.

In addition, the Council wishes to point out that, contrary to the statement on page 40 of the Report to the effect that this exception under

904 (f) (2) (C) is only provided in cases where the U.S. taxpayer receiving this interest directly owns 10% of the borrowing foreign affiliate, it believes that the intent of present law is that such a foreign affiliate may be either directly or indirectly owned by the U.S. company to come within the exception.

It will be recalled that when Secretary Dillon was examined by Senator Long with respect to his recommendation for a separate foreign tax credit limitation for certain investment income, he made it very clear that this provision was directed specifically to passive short-term funds that were invested abroad. This will be seen from the following questions and answers appearing on pages 4259 and 4260 of the record of Senate Hearings on the Revenue Act of 1962:

Senator Long. Mr. Secretary (Dillon), . . . You cited a flow of short-term funds to Canada and I believe you are correct in what you recommended with regard to that.

According to your testimony contained on pages 103 and 104 of the record, [attached hereto as Appendix A] and in greater detail at page 243, this change is intended to cover short-term investments abroad.

Am I correct in my understanding you do not intend this change to apply to dividends received by a U.S. corporation from another corporation, domestic or foreign in which it owns at least 10 percent of the voting stock?

Secretary Dillon. That is correct. No, it would not. It is only meant to handle this one specific short-term problem which I described in my April 2 statement.

Senator Long. Would I also be correct in understanding that you do not intend this change to apply to interest received from investments in such affiliates?

Secretary Dillon. No, it would not apply to interest received from such affiliates.

Senator Long. Now, do you intend this change to apply to interest received on a loan made to a foreign customer to secure an outlet for products to be sold to the lender?

Secretary Dillon. No. This was only meant to apply, in effect, to passive funds that were transferred abroad for the specific purpose of taking advantage of this situation in the law where there is an unused credit which allows totally tax-free treatment of the income from such passive funds by investment abroad.

Senator Long. I have been informed by some corporations occasionally that they are required to buy bonds in a Latin American country. They are not particularly anxious to buy them, but while they have no enthusiasm for the purchase, as a matter of good will in the country they are more or lesss compelled to do so.

And I take it that you would not intend your recommendation to apply to that either?

Secretary Dillon. No.

Senator Long. As long as it is limited to that, I think the recommendation should receive complete support. At least I would expect to support it.

However, to completely resolve these points, the Council urges that 904 (f) (2) (C) be clarified so as to exclude interest received from a corporation in which the recipient (or one or more includible corporations in an affiliated group, as defined in section 1504, of which such recipient is a member) owns directly or indirectly 10% or more of the total combined voting power of all classes of stock.

This wording is similar to that in section 4915 of the Code whereby direct foreign investments are excluded from the imposition of the Interest Equalization Tax. Direct foreign investments are spelled out by statute as investments of 10% or more of the total combined voting power of all classes of stock held either directly or indirectly by members of an affiliated group of corporations.

While this recommendation would eliminate the need for the special amendment to section 904 (f) for interest received by an "overseas operations funding subsidiary" on obligations of a related foreign corporation, the Council wishes to express its concern over the unduly restrictive proposed definitions of the terms "overseas operations funding subsidiary" and "related foreign corporation" contained in H.R. 13103.

The definition of the term "overseas operations funding subsidiary" as contained in the proposed section 904 (f) (5) (A) requires that such a subsidiary raise its funds through "public offerings." The Council is at a loss to understand why there should be a requirement that the offerings be public. The objectives of the balance of payments program will be satisfied if the funds are raised outside of the United States from foreign persons whether the offerings are public or private.

The definition of a "related foreign corporation" in proposed section 904 (f) (5) (B) requires that at least 50% of the voting stock of the foreign corporation must be owned either directly or through ownership of only one other foreign corporation included in the affiliated group of which the "overseas operations funding subsidiary" is a member.

First, it is felt this definition is too restrictive insofar as it requires the affiliated group to own at least 50% of the voting stock of the foreign corporation from which the interest income is received. This 50% requirement is to be contrasted with the 10% requirement of the existing section 904 (f) (2) (C) which makes the separate "per country" limitation inapplicable to interest income "received from a corporation in which the taxpayer owns at least 10% of the voting stock."

The apparent rationale of this 10% rule is that an interest-bearing loan to a corporation (earning all or most of its income abroad) is likely to be prompted by legitimate business considerations if the lender owns as much as 10% of the voting stock of the borrowing corporation. If this is the rationale of the present 10% stock ownership requirement, it should apply regardless of whether the loan comes from the 10% shareholder or from another U.S. corporation, such as an "overseas operations funding subsidiary," which is a member of an affiliate group of corporations (as defined in section 1504) to which the 10% shareholder belongs. There does not appear to be any logic in raising the stock ownership requirement from 10% to 50% simply because the loan and the stock are not held by the same member of the affiliated group.

Unless the proposed new 50% requirement is modified to conform to the present 10% requirement, a U.S. taxpayer owning at least 10% but less than 50% of the voting stock of a foreign corporation will find it advantageous to lend U.S. funds to the foreign corporation rather than to utilize an "overseas operations funding subsidiary" to lend foreign funds to the foreign corporation, thus adversely affecting the balance of payments position of the United States.

Second, the Council believes that the proposed amendment is too restrictive insofar as it specifies that the required voting stock of the foreign borrowing corporation be held by a member of the affiliated group either "directly or through ownership of the stock of another foreign corporation." According to the Report of the Ways and Means Committee at Page 41, "This latter requirement, in effect, means that the borrowing subsidiary may be either a first or second tier foreign subsidiary."

The Council can see no logical basis for denying the benefit of the proposed amendment to interest income received from third or fourth tier foreign subsidiaries. While it is true that dividends received from third or fourth tier foreign subsidiaries do not carry "deemed paid" credits under section 902, this does not afford a persuasive analogy because only interest income (and not dividend income) is affected by the separate "per country" limitation imposed by section 904 (f). It is arbitrary to give effect to stock ownership in first and second tier subsidiaries and to ignore the same percentage of stock ownership in third and fourth tier subsidiaries.

Incidentally, the Council has recently indicated its support of H.R. 15139, introduced by Congressman Secrest, which would amend section 902 of the Internal Revenue Code to reduce the 50% ownership requirement to 25% between the first and second levels and extend the benefits of section 902 to dividends received from a third level foreign corporation if the 25% test is met.

As stated above, the 10% stock ownership requirement appears to be premised on the view that an interest-bearing loan to an affiliate is likely to be motivated by genuine business considerations (rather than tax-saving considerations) if the lender is at least a 10% stockholder. If this assumption is valid (as the Council believes it to be), it is equally valid regardless of whether the 10% stock interest is held directly or through any number of intermediate subsidiaries.

Interest Received In Connection With Certain Dispositions

Under present law an exception to section 904 (f) is provided where the interest received is on an obligation acquired as a result of disposition of stock or obligations of a corporation in which the taxpayer owned at least 10%. However, in the case of a disposition of stock of a wholly-owned subsidiary of a corporation in which the taxpayer owns a 10% interest the latter exception may not apply under present law. It appears that the limitation on the foreign tax credit should apply in the same manner if the obligation is acquired as a result of disposition of the stock of a corporation owned at least 10% whether directly or indirectly.

APPENDIX A

Eliminating Artificial Tax Incentives To Capital Movements Arising Out Of Foreign Tax Credit Computation[9]

Last summer Canada revised its tax laws to provide a 57½% effective rate of Canadian tax applicable to income going to United States corporations operating in branch or subsidiary form in Canada. This Canadian tax rate in excess of the U.S. 52% rate has highlighted the operation of the existing method for computing the foreign tax credit as an artificial inducement to the outflow of short-term U.S. capital. This is harmful to our monetary stability and to our balance of payments position.

Under existing rules, a U.S. company deriving income from business abroad through a branch or a subsidiary may have an unused foreign tax credit where the foreign rate of tax on the income exceeds the U.S. rate. If, however, additional foreign source investment income can be generated which is subjected to a foreign tax rate lower than the U.S. rate, the two kinds of income can be lumped together under the existing foreign tax credit rules. In this way the U.S. tax on the income from such investment funds can be completely eliminated by the excess credit from the tax on the business income of the company.

For example, the 57½% effective rate of Canadian tax applicable to income going to U.S. corporations operating in branch or subsidiary form in Canada leaves an excess credit of 5½% over the U.S. 52% rate. The Canadian rate of tax on interest income flowing to such corporations is only 15%. Consequently, some of these U.S. corporations have transferred to Canada short-term funds, such as bank deposits, which ordinarily would be held in the United States. Since the excess credit from the business income will eliminate the U.S. tax on the interest income, the effect is to leave that income taxable at only a 15% Canadian rate, as compared with the 52% U.S. rate that would apply if the funds were held in the United States. Thus the existence of this situation serves as an artificial inducement to the movement of U.S. capital abroad.

In my report to the President on the balance of payments, transmitted to the Congress on March 28, 1962, I recommended that this situation be corrected. I suggest that the foreign tax credit for certain investment income be computed apart from the foreign tax credit for all other foreign income. In this way a foreign tax credit will be allowed against investment income only for the actual foreign taxes paid on such income. This will result in the same tax rate being paid with respect to short-term investment income of U.S. companies whether it is earned at home or abroad. We believe that this is an effective and fair way to correct this tax-induced disruptive monetary situation. A more detailed explanation of this recommendation and the proposed statutory language is submitted as exhibit III E.

[9] Excerpt from testimony of Secretary Dillon at Hearings before Senate Finance Committee on the Revenue Act of 1962 (Part 1, pages 103 and 104).

(By direction of the Chair, the following communications are made a part of the record at this point:)

NATIONAL ASSOCIATION OF MANUFACTURERS,
Washington, D.C. August 9, 1966.

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

DEAR MR. CHAIRMAN: This letter is in response to your Committee's invitation to submit written statements on H.R. 13103, the Foreign Investors Tax Act of 1966. This legislation has been the subject of continued study by the NAM Subcommittee on International Taxation since the original version was first introduced.

Our concern with H.R. 13103 is focused largely on the "effectively connected income" test. On March 4, 1966, we told the House Committee on Ways and means, "* * * that unless this new concept is carefully drawn and applied, it invites a host of questions and uncertainties in the existing U.S. source rules." These "questions and uncertainties" still exist and indeed further study reaffirms our doubts.

The basic purpose of H.R. 13103, with which we have no quarrel, is to attract foreign investment capital to the U.S. The collateral purposes with which we also agree in principle are:

(a) To prevent the U.S. from being used as a tax haven by foreign corporations, and

(b) To impose a U.S. tax on income generated from U.S. business activities—otherwise not taxed—.

It is the implementing provisions to effect these latter purposes about which we have serious doubts. The "effectively connected income" test is a jurisdictional test which would be imposed on and would supplement our present source of income rules. It is subjective and fuzzy in its measurements and application. Taxes would turn on such concepts as: material participation in—activities attributed to—etc. Practical questions of proof are consequently raised. Further, materiality and taint would, in a number of instances lead to multiple taxation.

The present rules, while being jurisdictional themselves, are well understood both here and abroad. The proposed rules seriously lack the precision of the old, and were they superimposed, in many instances, would lead to controversy as to which would apply or, perhaps, to a situation where all would apply.

Other troublesome areas immediately come to mind. What would be done, for example, in the tax treaty area? The proposed rule conflicts with the jurisdictional tests in a number of our tax treaties with other countries. How are the resulting conflicts and inconsistencies to be corrected?

These provisions of the bill, H.R. 13103, are not expected to increase revenues. However, they would add imprecision and confusion to our present well-tested and precise rules of source and jurisdiction. Any changes in these existing rules for any purpose should be the subject of more careful consideration as to their ultimate effect in areas not contemplated or presently considered in the drafting of the bill now before your Committee.

We respectfully request that this letter be made part of the official record of the Committee's hearings.

Sincerely,

D. H. GLEASON,
Chairman, Subcommittee on International Taxation,
NAM Taxation Committee.

MANUFACTURING CHEMISTS' ASSOCIATION, INC.,
Washington, D.C., August 10, 1966.

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

DEAR MR. CHAIRMAN: Reference is made to your Committee's announcement of public hearings on H.R. 13103, The Foreign Investors Tax Act of 1966. The purpose of this letter is to present the views of the Manufacturing Chemists Association (MCA) concerning this bill. For your information, MCA is a nonprofit trade association with 102 U.S. member companies, large and small, which together account for more than 90% of the productive capacity of the chemical industry in the United States.

This Association is opposed to the provisions contained in H.R. 13103 which embody the concept of "effectively connected" so as to impose United States tax on foreign source income of foreign corporations doing business in this country. It is our belief that sufficient documentation has not been developed as to the necessity of introducing this new and novel concept into the tax laws and that the resulting confusion and burdens would be substantially disproportionate to the abuses which are sought to be remedied. Our specific objections to these provisions are set forth below.

1. The terms "effectively connected" and "participated materially" embodied in H.R. 13103 remain vague and ambiguous despite attempts to clarify them. The numerous issues which will be raised and the extensive litigation which will follow in interpreting their meaning and scope will create undue and unnecessary burdens on taxpayers and the Government alike.

2. Adoption of the present version of H.R. 13103 would create insurmountable accounting and auditing problems for taxpayers and the Internal Revenue Service. For instance, where goods are manufactured by a corporation abroad and sold for consumption abroad through use of a sales office in the United States, the selling profit must be allocated to and taxed in the United States. Since all of the personnel and records of such corporation probably are abroad, except for possibly one salesman, considerable difficulty will be experienced by the Internal Revenue Service in any audit. Even where such audit is conducted, it will be an impossibility to determine the proper income attributable to the United States sale since advertising, selling expenses, etc. incurred at some previous time during the year might have to be allocated to this sale under conditions where no rules have been established.

3. It has been pointed out that H.R. 13103 is designed to tax certain foreign source sales solely because the income therefrom escapes tax completely. However, the net result of the proposal will unnecessarily harm the United States balance of payments since to avoid such tax, a foreign corporation need only move its sales office to a more receptive country, thereby eliminating the present flow of funds into the United States to pay for the sales office and the employees' salaries.

4. While the Association commends the exclusion of subpart F income from being considered "effectively connected" with the conduct of a trade or business in the United States, there is need for further clarification of this relief. For example, if a foreign base company is not subject to subpart F because less than 30% of the gross income of the corporation is subpart F income, does the relief granted under Section 954(b)(3) become nullified through the "effectively connected" provisions of H.R. 13103? It would seem that the intent of the bill is to grant the exclusion under these circumstances, but this should be indicated more clearly.

5. H.R. 13103 brings within its new concept of "effectively connected", rents or royalties derived for use or for the privilege of using intangible property located outside the United States. This is another example where the criteria to be used in determining whether the "effectively connected" concept applies are vague and unclear. Although the House Ways and Means Committee report sets out some general principles, taxpayers will continue to be uncertain as to whether the activities performed in the United States are such as to require these items to be attributed to the United States office. MCA believes that it would be desirable to provide a rent and royalties requirement similar to that which is applicable to foreign income from sales, namely, that rents and royalties will not be considered effectively connected to a United States office where the taxpayer has an office outside of the United States which "participates materially" in the negotiation of the leases and licenses or participates in the servicing of the rights thereunder.

For the above stated reasons, this Association recommends the complete deletion of the "effectively connected" provisions referred to above from H.R. 13103. On the assumption, however, that your Committee may deem it advisable to continue to include these provisions in the bill, it is suggested that the bill be limited to its original purpose of dealing with foreigners by a simple amendment which would exclude from the bill those foreign corporations now subject to United States scrutiny because they are controlled by United States persons. This can be done simply by deleting the present language of Section 864(c)(4)(D)(ii) and substituting the following language:

"(ii) is derived by a foreign corporation more than 50% owned directly or indirectly, by United States persons".

The Association also strongly recommends that H.R. 13103, if enacted, be revised so as to extend a foreign tax credit for foreign income taxes imposed by the home country of the taxpayer on foreign income "effectively connected" with the conduct of a trade or business within the United States. For example, if the country in which a foreign corporation is organized imposes an income tax on foreign income which under H.R. 13103 is considered "effectively connected" with a trade or business in the United States, a foreign tax credit for those taxes should be allowed. It is well known that many nations tax income of their taxpayers whether derived from sources within or without the country. In such cases, H.R. 13103 would cause double taxation by requiring United States taxation of the same income taxes by the home country of the taxpayer. MCA believes that where income under these circumstances is doubly taxed, the United States should grant a foreign tax credit.

We appreciate this opportunity to present our views for your consideration and request that they be made a part of the printed record of the Committee's hearings.

Sincerely,

G. H. DECKER.

Senator ANDERSON. Mr. Seghers.

STATEMENT OF PAUL D. SEGHERS, PRESIDENT, INSTITUTE ON U.S. TAXATION OF FOREIGN INCOME, INC.

Mr. SEGHERS. Thank you for the opportunity to appear. For the record, my name is Paul D. Seghers, appearing as president of the Institute on U.S. Taxation of Foreign Income, Inc.

I am not reading from my written statement that was filed. We thank you for this opportunity to present our views regarding the Foreign Investors Tax Act of 1966. Before commencing my oral presentation, I wish to mention the magnificent report on this bill submitted by the Interstate Tax Committee, New York State Bar Association. It clearly and dispassionately states the facts regarding the objectionable features of this bill, penalizing exports of U.S. products, and the harmful effects it would have on our economy and our relations with friendly nations.

This is presented in 108 pages of text and 11 pages of summary. This is fortunate, as it would be impossible to begin to deal adequately with these extremely complicated and confusing provisions in an oral presentation.

Very few of us would be here today if this bill were the same as originally introduced, H.R. 5961. In fact, I have a feeling that many of us would not be here today, if the effect of this bill were as stated, in its behalf. However, even the brightest picture reveals clearly that it would impose new burdens on the export and sale abroad of U.S. products.

Limit its effect to foreign investors, and foreign-owned corporations and opposition to this bill would evaporate.

We offer no comments regarding the provisions of this bill which are in harmony with its title and stated purpose and are in fact intended to accomplish its purpose as originally stated by the Treasury, the increased foreign investment in the United States. We are concerned with those provisions that have nothing to do with the stated purpose of this bill but would place further burdens of harassment as well as taxes on U.S.-owned foreign corporations, particularly those selling abroad U.S. products of U.S. parent companies.

Just why such sales are the special target of attack by the Treasury we cannot understand. These sales already have been singled out for special attack under subpart F of the 1962 revenue act and this bill would impose additional burdens, difficulties and harassment on foreign corporations making such sales abroad.

H.R. 13103 would tax corporations on income earned abroad, on income heretofore believed beyond the taxing power of the United States not even attempted in the 1962 Revenue Act. Yet the Ways and Means Committee report on H.R. 13103, at page 7, shows that these burdensome provisions would produce no tax revenue for the United States. Then why do we protest against them? Because even if they did not extract one penny of taxes these provisions would place heavy burdens of accounting, reporting, and vouchering upon all foreign corporations with any employees or agents in this country.

How complicated and how burdensome these requirements would be are set forth in many pages of the bar association report to which reference has been made.

This bill would not conform to foreign tax systems but would add to the present maze of U.S. tax rules other foreign rules and radical new theories.

Business does not want to be forced to depend on legislative history to explain theories too difficult to explain in the statute. It is not necessary to say "effectively connected" to make clear our objection.

To sum up: It is our hope that your committee will make a thorough study of the provisions of this bill which go beyond its stated purpose. We ask that you give careful consideration to the many excellent statements filed with you regarding the defects and harmful features of this bill as it affects U.S. exports.

The provisions of H.R. 13103 which are aimed at U.S.-owned foreign corporations selling U.S. products abroad would further discriminate against export of U.S. products. It is vastly complicated; unworkable tests applicable to income of foreign corporations from their sales abroad of U.S. products would result in confusion and endless dispute, and to what end? We again emphasize that the Ways and Means Committee report shows no tax revenue from these objectionable provisions.

If it is clear that it will have a harmful effect on our economy and will produce no revenue, why should they be enacted? The Foreign Investors Tax Act of 1966 could accomplish its stated purpose without these provisions as was done in the original bill H.R. 5918. If your committee weighs the facts and arguments against the radical new theories which these provisions would implant in our tax law, we believe you will conclude that they are not desirable and should not be enacted.

U.S. tax incentives for exports are needed, not U.S. tax penalties on U.S. exports.

Thank you.

(Mr. Seghers' prepared statement follows:)

STATEMENT OF PAUL D. SEGHERS, PRESIDENT, INSTITUTE ON U.S. TAXATION OF FOREIGN INCOME, INC.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

1. This institute heartily agrees with the oft-stated purpose of this Bill—to afford tax incentives for investment in the United States by foreigners.

2. Our objection is to the provisions in this Bill which would impose further U.S. tax burdens on U.S. foreign trade, especially U.S. manufacturers exporting their products for sale through foreign subsidiaries.

3. Despite the substantial improvements in the language of the latest Bill concerning foreign income "effectively connected" with business activities in the United States, we insist that that theory is wrong in principle and will have adverse effects on the U.S. economy.

4. To avoid further handicapping U.S. concerns engaged in foreign trade, it is essential, if the "effectively connected" theory is retained, to provide that this theory is not to be applied to foreign corporations majority-controlled by U.S. persons. We make no *alternative* recommendations for *improving* these very complicated and troublesome provisions, as the one change we recommend will be sufficient to eliminate the harm to U.S. business engaged in foreign trade.

5. The House Ways and Means Committee report on H.R. 13103 (p. 7) shows that its "effectively connected" provisions would produce no tax revenue. Hence, there is no revenue barrier to deter eliminating this complicated source of uncertainty and endless disputes and difficulties.

6. The proposed radically new provisions for disallowance of credit for foreign income taxes would, in certain circumstances, result in severe and unjustifiable hardship through double taxation, even if the "effectively connected" provisions were limited as recommended above.

7. We are convinced that the stated objectives of this Bill could be achieved by the use of very much simpler and more direct language, and doubt that the present provisions of H.R. 13103 regarding U.S. income and activities of foreign-owned foreign corporations would go far towards accomplishing its stated purpose.

1. Stated purpose of H.R. 13103 is heartily approved

This institute heartily approves of the oft-repeated purpose of H.R. 13103 (and its predecessors, H.R. 5916 and H.R. 11297)—"to increase foreign investment in the United States," as expressed in the Treasury Department's March 8, 1965, statement.

This purpose was again stated in the report on H.R. 11297 published by the House Ways & Means Committee for the use of its members, as follows:

"* * * to modernize the present U.S. tax treatment of foreigners and to encourage foreign investment in the United States * * * by removing tax barriers to such investment."

In its report on the present version of this proposed legislation (H.R. 13103) the House Ways & Means Committee is less specific in stating the purpose to encourage foreign investment in the United States and has restated the modified purpose of the bill as:

"* * * designed to increase the equity of the tax treatment accorded foreign investment in the United States."

With both stated purposes we are thoroughly in accord. What concerns us is the provisions in the present bill which would place new and previously believed to be impossible burdens of U.S. income tax on income earned abroad by foreign corporations, particularly those selling abroad U.S. products of U.S. parent companies. Just why such sales are the special target of attack, we can not understand.

2. Objection to use of H.R. 13103 to burden our foreign trade

H.R. 11297 would have constituted an oppressive burden on U.S. foreign trade. While H.R. 13103 goes far to avoid this evil, it still presents a threat to all U.S.-owned foreign subsidiaries engaged in foreign trade, especially in the case of U.S. manufacturers exporting and selling their products abroad through such subsidiaries. Such added burden is in no wise consistent with the purpose of affording incentives for foreign investment in the United States, nor with efforts to encourage export of U.S. manufactured products.

Comments regarding specific ways in which this Bill would impose added burdens on U.S. businesses engaged in foreign trade are given in statements filed with your Committee by other organizations.

We make no comments or recommendation herein regarding the possibly adverse effects of H.R. 13103 on *foreign*-owned foreign corporations. We are concerned here only with its adverse effects on U.S. business and the U.S. economy.

3. The radical new "effectively connected" theory is wrong in principle

The feature of H.R. 11297 which led to a storm of protest against that version of the proposed legislation was the fact that it would have subjected foreign corporations to U.S. tax on income earned by them outside the United States by broadly applying the radical new "effectively connected" theory. That theory seems to be that every foreign corporation should pay U.S. tax on all income it earns anywhere in the world *outside* the United States, if such income is "effectively connected" with business activities by it in the United States.

Although H.R. 13103 has substantially modified and restricted the application of this "effectively connected" theory, it still pervades the Bill, the phrase being repeated scores of times throughout the first 63 of its 82 pages. The exact meaning of this phrase defies definition.

It is so vague that it would cause endless uncertainty, confusion and disputes. This is one point on which all who have examined this Bill and its predecessor agree. We believe that no amount of "legislative history" could adequately cure this defect.

One of the serious defects in this respect is that H.R. 13103 apparently would tax *all* of any item of income earned abroad which was "effectively connected" with certain United States activities of a foreign corporation, without regard to the *extent* that such income was "attributable" to those activities.

This is contrary to the intention clearly expressed in the House Ways & Means Committee report, to limit the application of the "effectively connected" theory so as to tax only so much of the foreign earned income as is attributable to activities in the United States. (p. 16) However, in its present form, H.R. 13103 makes no provision for any allocation, but would levy the tax on an "all-or-nothing basis. This will be confirmed in statements filed by others with your Committee.

4. Recommended limitation of application of the "effectively connected" theory so as to exclude U.S. controlled corporations

In order for this Bill to afford U.S. tax incentives to foreign investment in this country, application of the radical new "effectively connected" theory to U.S. owned and controlled corporations is not necessary; would be harmful; and should be eliminated.

This could be accomplished by substituting for the presently proposed new IRC Sec. 882(b) the following:

"SEC. 882. INCOME OF FOREIGN CORPORATIONS CONNECTED WITH UNITED STATES BUSINESS.—

* * * * * * *

(b) GROSS INCOME.—

1. In the case of foreign corporation 50 percent or more of the stock of which is owned, directly or indirectly, by United States persons (as defined in Section 957(d)), gross income includes only gross income from sources within the United States and,

2. In the case of all other foreign corporations, gross income also shall include gross income from sources without the United States which is effectively connected with the conduct of a trade or business within the United States.

The foregoing proposed provision would take away from foreign investor-owned foreign corporations no benefits which they would be able to obtain under the present provisions of H.R. 13103.

Another, simpler method to accomplish exactly the same purpose, with fewer changes in wording and cross-references, would be to reword the proposed new Sec. 864(c)(4)(C) (page 16 of the Bill as introduced) as follows:

"(C) No income, gain, or loss from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States if it either—(i) is derived by a foreign corporation, more than 50% owned, directly or indirectly, by U.S. persons, or (ii) is subpart F income within the meaning of section 952(a)."

5. No revenue considerations to bar elimination of the "effectively connected" provisions of H.R. 13103

The Ways & Means Committee report on H.R. 13103 (p. 7) shows that its "effectively connected" provisions would produce no tax revenue. Hence, the need for tax revenue can not be used as an argument against the elimination of this complicated source of uncertainty and endless disputes and difficulties, with all its undesirable features.

6. Proposed disallowance of credit for uncertain foreign income taxes

H.R. 13103 would disallow credit (or deduction) for foreign income taxes imposed on a foreign corporation if—

(1) Such taxes were imposed by reason of its place or organization or domicile, or

(2) Such taxes were incurred as a result of steps taken for tax saving reasons.

A mere statement of these tests should be sufficient to condemn them.

The first test would penalize the payment of foreign taxes imposed by a foreign government on a foreign corporation on the same basis as the United States has always claimed jurisdiction to tax corporations organized in this country.

The second test is purely subjective and would subject a foreign corporation to double taxation on the basis of what it might have done, rather than what it did.

Others will present to this Committee more specific comments and recommendations regarding this proposed foreign tax credit disallowance, which would be in addition to all existing restrictions and limitations on the amount allowable as a foreign tax credit.

We ask this question: In what way would this provision for the disallowance of credit (or deduction) for uncertain foreign income taxes, operate as an incentive for foreign investment in the United States?

7. Desirability of simplification of language and concepts. Doubt as to attractiveness to foreign investors of proposed income tax provisions

We believe that the stated objectives of this Bill could be attained more satisfactorily by the use of much simpler and well-recognized principles.

If it is desired to make radical changes in the half-century old principle of source of income, that should be considered separately, on its merits.

We doubt that, on balance, the *income tax* provisions of H.R. 13103 will afford much incentive to *foreign* investors.

It is beyond the scope of this statement to labor further these points. We will only add that no U.S. business man relishes the need for a legal opinion as to the possible tax consequences of every export shipments of goods to or by a subsidiary.

Senator ANDERSON. Thank you very much. I am sorry we were so late.

Mr. Page, do you want to testify tomorrow or now? Come right ahead.

Mr. Seghers, I was glad to hear you refer to that New York document. I read it yesterday, and I thought it was a very good piece of work.

STATEMENT OF WALTER H. PAGE, REPRESENTING THE NEW YORK CLEARING HOUSE ASSOCIATION; ACCOMPANIED BY DAVID LINDSAY, COUNSEL TO MORGAN GUARANTY TRUST CO., OF NEW YORK

Mr. PAGE. Senator Anderson, my name is Page, Walter Page. I am executive vice president of the Morgan Guaranty Trust Co., of New York, in charge of their international business. My bank is a member of the New York Clearing House Association, and I am representing the clearinghouse here. I have with me Mr. David Lindsay, counsel to my bank.

The New York Clearing House is made up of 10 banks which are listed as an appendix to this statement I have filed.

Senator ANDERSON. I will just say to you, Mr. Page, you did well to bring Mr. Lindsay along. He was with the Treasury for many years and was very kind to this committee and we have great respect for him.

Mr. PAGE. Thank you. I am very glad he is here.

Senator, I will not read my statement here. I do want to emphasize that the New York Clearing House very strongly opposes the two provisions which will impose taxes on bank deposits. One is the estate tax which would be effective immediately upon enactment of this bill, and second is the income tax which will become effective as recommended in this bill in 1972.

Senator ANDERSON. Did you hear the questions that I raised earlier today?

Mr. PAGE. I did indeed, sir.

Senator ANDERSON. Would you think, if those two items were taken out, there still would be a bill worth passing?

Mr. PAGE. I do not know that I am qualified to answer the major questions which Mr. Seghers has just detailed or summarized to you.

Senator ANDERSON. Well, the problem comes to this: Should the Finance Committee of the Senate try to bring out a bill without those two sections in it, since there is a great deal of objection to it, and consider those more thoroughly at a later date?

Mr. PAGE. Yes, I think that the Finance Committee, perhaps, should look at this bill very carefully. Certainly the original purpose of this bill to increase foreign investment in the United States is something that I, myself, representing my own bank, would be very much in favor of. I do know that these two taxes on bank deposits can have a very bad effect on our balance of payments. I am not sure I have fully followed your question there, Senator, fully answered it.

Senator ANDERSON. In politics sometimes you have to take the best solution you can find.

Mr. PAGE. Yes.

Senator ANDERSON. If a great many people are opposed to H.R. 13103 because of these two items you have mentioned, and they were to be taken out of the bill, would there still be something worth salvaging in the bill?

Mr. PAGE. For myself and my own bank, I would say we would be in favor of its passage, of taking out these provisions I mentioned and a further look at this "effectively connected" concept.

Senator ANDERSON. Is your manuscript there in such shape that the reporter can handle it and put it in the record as if read?

Mr. PAGE. I am not sure I heard.

Senator ANDERSON. Can the reporter take your manuscript and put it in the record as if read?

Mr. PAGE. We have already filed it with the committee. I would like to expand on one thing. Senator Talmadge earlier mentioned the figures of bank deposits and Secretary Fowler mentioned a figure of $2.5 billion as the bank deposits from foreigners in the United States which would be affected by this bill. The New York Clearing House, the 10 member banks, have each reported confidentially to the clearinghouse their own figures. These total approximately $1.9 billion. Of that $1.9 billion, $1 billion is of individuals, foreign individuals, deposited in these 10 banks in New York on which interest is paid. Another $400 million is the demand deposits from foreign individuals in New York banks on which no interest is paid, of course. A further half a billion dollars, $500 million, is from foreign corporations and other private entities abroad, not foreign central banks or official institutions. That makes up the $1.9 billion in these 10 banks in New York.

We have no firm figures on the total for the country, but obviously it is going to be considerably in excess of the figures in New York.

I do want to make one other point, Senator, which is in my memorandum, but which has not been mentioned this morning. Senator

Dirksen has proposed an amendment to this bill which would effectively amend the Interest Equalization Tax Act. This would enable the foreign branches of American banks to make dollar loans without regard to the interest equalization tax. Today, whether we make—an American bank—makes a dollar loan from the United States or from its foreign branch, it is subject to the interest equalization tax in the same way. But American banks have a considerable amount of dollars deposited in their branches abroad which are foreign source dollars. We feel that it would be of benefit to the balance of payments if we were allowed, in foreign branches of American banks, to make dollar loans of a year or more where the interest equalization tax would not affect it, so that we would be in full competitive stance with our foreign bank competitors. We feel that this would also help the balance of payments because we have a very heavy demand from the foreign subsidiaries of American companies for 2-, 3-, or 4-year term loans abroad which we cannot now make without being subject to the additional tax penalty of the IET. We feel this is a step which would help the balance of payments today, and enable the American-owned subsidiaries abroad to further develop without any drain on our balance of payments, and in fact, by that development, send further earnings back here.

This is detailed in our statement here. We have a lot of figures.

I might mention one other point. Senator Talmadge particularly asked Secretary Fowler, or perhaps you did also, sir, as to what countries the theoretical depositor from Latin American countries might move his deposit to avoid estate and income tax. There are many in this world.

Perhaps we should really concentrate on the developed countries because I do not believe that the depositor would put his money in a very small country which had no stability. But effectively we believe that the taxes are such in the United Kingdom, in Belgium, in France, and in Germany that he would not be subject to income tax or estate tax if he held his deposit in dollars in those countries which certainly opens a big field for him.

Senator ANDERSON. Yes, I know.

Mr. PAGE. I believe that is all I need to say.

(Mr. Page's prepared statement follows:)

SUMMARY STATEMENT OF WALTER H. PAGE, FOR THE NEW YORK CLEARING HOUSE ASSOCIATION ON H.R. 13103

1. *Bank Deposits.*—Two provisions of H.R. 13103 relating to bank deposits are not believed to be in the best interests of the United States. One would subject bank deposits held here by non-resident alien individuals to United States estate taxes, effective upon enactment. The other would subject interest earned on bank deposits held here by non-resident aliens to income tax withholding, effective in 1972. These provisions seem irreconcilable with present day international financial policies, would, it is believed, have a detrimental effect on the United States Balance of Payments and are not likely to produce significant revenue or achieve meaningful tax equity.

2. *Foreign Branch Loans.*—The New York Clearing House Association supports the Dirksen Amendment, amendment No. 717 to H.R. 13103, which would allow the President to exempt dollar loans made by foreign branches of United States banks from the interest equalization tax. The amendment would support the Administration's balance of payments program that encourages the financing of foreign subsidiaries of U.S. corporations out of funds located abroad.

STATEMENT OF WALTER H. PAGE, FOR THE NEW YORK CLEARING HOUSE ASSOCIATION ON H.R. 13103

Mr. Chairman, and gentlemen of the Committee, my name is Walter H. Page. I am Executive Vice President of the Morgan Guaranty Trust Company of New York, a member of the New York Clearing House Association. I have with me Mr. David A. Lindsay, counsel to my bank. We are appearing for the New York Clearing House Association which consists of ten member banks, listed at appendix A, attached to my prepared statement.

I. PROVISIONS AFFECTING BANK DEPOSITS—ESTATE AND INCOME TAX

H.R. 13103, the Foreign Investors Tax Act of 1966, contains two provisions relating to bank deposits held in the United States by non-resident aliens which:

(1) Represent a reversal in long standing policy;

(2) Are irreconcilable with the urgent present day international financial policies and interests of the United States; and

(3) Are inconsistent with the purposes underlying the administration's original impetus for the Bill and are not likely to accomplish effectively their present purpose.

1. Provisions described and stated purpose

One of these provisions would be subject bank deposits held here by non-resident alien individuals to United States estate taxes on the death of such non-resident alien individuals. This provision is proposed to have immediate effect upon enactment.

The other provision would subject interest earned on bank deposits held here by non-resident aliens, individual, corporate and institutional (excepting foreign central banks and governments and international institutions) to income tax withholding, effective in 1972. The Congress deliberately exempted such interest from tax (and the bank deposits from the estate tax) in the case of non-resident aliens in the Revenue Act of 1921.

The proposed changes are made in the name of "tax equity." One can understand their appealing logic. Residents are taxed on these items. Why exempt non-resident aliens? The difficulty is that bank deposits can be readily moved out of the United States or even if kept here can be insulated (in ways beyond the control of domestic banks) from the reach of the Commissioner of Internal Revenue. The proposed new tax provisions affecting bank deposits simply will not catch the sophisticated dollar holder. They will, on the other hand, have detrimental effects on the balance of payments and the control of the U.S. authorities on our own currency.

2. Effect of provisions on dollar deposits

The estate tax provisions would have the most immediate impact. According to a confidential survey by the New York Clearing House Association its ten member banks hold almost $1.4 billion of deposits for non-resident alien individuals of which about $1 billion are on a time deposit and about $400 million on a demand deposit basis. The aggregate for all banks in the United States is considerably higher. All of these deposits would be potentially affected by the estate tax provisions. Because of the threat of the present bill some such deposits have already been removed and steps have been taken to move additional ones. The removal of these deposits can be accomplished simply and quickly. It is, therefore, hard to imagine that this estate tax provision will produce significant revenue to the United States or achieve meaningful tax equity.

The proposed delayed tax on interest earned on domestic dollar deposits of non-resident aliens potentially affects all interest bearing savings and time deposits (including certificates of deposit) in the U.S. exclusive of so-called "official" accounts. As far as the ten member banks of the New York Clearing House are concerned, the total of these deposits is about $1.5 billion and, again, the total for all U.S. banks is considerably higher. The delay was no doubt adopted in light of problems concerning our balance of payments and gold problem. The provisions, therefore, may be characterized as a red flag or warning to foreign depositors of the present intent of this country as to future action. Again, because of the fluid nature of bank deposits, the income tax provisions would probably have little or no revenue impact even if effective immediately upon enactment. The delayed impact is most difficult to measure, but certainly any movements thereby induced will be in the wrong direction, and increasingly so, as the deadline approaches.

3. Effect of provisions on U.S. balance of payments and monetary policy

One direction which these domestic dollar deposits may go because of these two provisions in the proposed Act is into investments abroad in other currencies. This would involve the sale of dollars in foreign exchange markets with the bulk of them ending up in the dollar holdings of those central banks that are gaining reserves. In this manner they become a potential claim against the United States gold reserve.

Another direction which the domestic dollar deposits may go is the Eurodollar pool. This would remove these dollars effectively from the control and reporting procedures of the United States and their employment would, thereafter, not necessarily be in accord with U.S. monetary policy. Also some of the funds in the Eurodollar pool are used in a manner involving temporary conversion into foreign currencies. This could create a claim against the U.S. gold reserve as in the case of foreign currency investments that I mentioned before.

4. Conclusion

We feel that these two provisions of the Bill are not in the best interests of the United States. The delay in the income tax provisions only slightly mitigates its adverse effect. Capital in this world is notoriously timid; it very sedlom goes where it is not wanted. With the warning of future action advertised to the world very little new money will enter and we think a lot will leave well before the end of Decmeber, 1971. Both of the taxes proposed are new in concept, not in accordance with the Fowler Committee Report, and would, we think, have a detrimental effect on the United States balance of payments.

II. AMENDMENT NO. 717 TO H.R. 13103—LOANS BY FOREIGN BRANCHES OF COMMERCIAL BANKS REPAYABLE IN DOLLARS

The New York York Clearing House Association supports the Dirksen Amendment, amendment No. 717 to H.R. 13103, which would allow the President to exempt dollar loans made by foreign branches of United States banks from the interest equalization tax. In the present situation where United States business abroad in cooperation with the Department of Commerce is exploring every avenue to finance expansion without a drain on the United States balance of payments it seems obvious that this source of foreign financing should not be severely handicapped by a 1% tax penalty. The Voluntary Restraint Program as applied to banks by the Federal Reserve as well as the reports made weekly and monthly by foreign branches of United States banks to the Federal Reserve ensure that this exemption will not be abused. Extending and expanding the principle of flexibility originated in the Gore Amendment to the IET which allows the Executive to move quickly in this fluid area, seems appropriate. We, therefore, feel that this amendment should be adopted as part of H.R. 13103. A detailed memorandum on its purposes is attached.

MEMORANDUM

EXEMPTION FROM INTEREST EQUALIZATION TAX FOR DOLLAR TERM LOANS FROM FOREIGN BRANCHES OF U.S. BANKS

We feel it is in the best interests of the United States to exempt from the Interest Equalization Tax U.S. dollar loans made by the foreign branches of U.S. banks regardless of maturities involved. We believe that this exemption should be attained because it would be of considerable net benefit to the U.S. balance of payments. The present application of this tax restricts the activities of American bank branches in a business that is desirable from a balance of payments point of view and it shifts this business to their foreign competitors. It limits the ability of the American branches to provide a type of financing that the Department of Commerce recommends the U.S. corporations as being in the interest of its balance of payments program.

These dollars are, of course, those deposited in the foreign branches of U.S. banks by foreign owners. In the past some authorities have worried that exempting foreign branch dollar loans from the IET would mean that the head offices of American banks would channel some of their domestic funds to their foreign branches to make these loans. This channel is now blocked by the Federal Reserve Voluntary Restraint Program and the weekly reports to the Treasury made on form 3953.

On the positive side, we feel that the foreign branches of U.S. banks are one of the primary sources looked to by U.S. corporations to finance their operations and expansions abroad. The foreign branches of U.S. banks have been confronted during the past year with a heavy demand for Eurodollar loans with maturities of up to five years. This demand has come primarily from U.S. corporations and their European subsidiaries because of the Department of Commerce Restraint Program. Would-be borrowers have been looking for these loans because these maturities best fitted their cash flow from foreign earnings; because of the ease and often lower cost of making bank loans as compared to public bond issues; and their reluctance to sell convertible bond issues. The foreign branches of U.S. banks have been unable to meet this demand in a meaningful way because the Interest Equalization Tax represented too much of an additional cost. To some extent their place has been taken by foreign banks that are not subject to the tax. Earnings on such loans have accrued to these foreign banks instead of to the U.S. banks and the U.S. balance of payments.

There is another way in which increased ability to make dollar bank loans out of foreign branches would be beneficial to the U.S. balance of payments. In the Eurodollar area the foreign branches of U.S. banks do not in general lend for long maturities against short deposits. Therefore, the ability to make long loans would be an important incentive to induce depositors to lengthen their maturities with the foreign branches. This in turn would delay the point where these funds could become a claim on U.S. gold.

It is true that foreign branches may now make loans in foreign currencies free of the IET. However, the banks have not been able to make effective use of this exemption for foreign currency loans. Deposits in branches of U.S. banks are largely in dollars and it is not possible to swap these dollars into foreign currencies for sufficiently long maturities. American branch banks overseas attract only limited amounts of longer term foreign currency deposits because: 1) the majority of clients are subsidiaries of U.S. companies operating to a large extent in borrowed funds and remitting dividends, now in larger percentages, to parent companies; 2) truly international, non-U.S. sources tend to hold their excess funds in U.S. dollars, and 3) local companies, except as they have extensive dollar oriented business, tend to deal with native banks.

We would like to mention also that the ability of U.S. subsidiaries to obtain medium-term Eurodollar loans could become even more important if local currency loans in developed countries become further restricted by market conditions or government restrictions. As an example, the Bank of England has restricted the sterling borrowing of foreign owned companies but at the same time has indicated permission for Eurocurrency borrowings under certain conditions.

Appendix A. The New York Clearing House Association

MEMBER BANKS

The Bank of New York.
The Chase Manhattan Bank.
First National City Bank.
Chemical Bank New York Trust Company.
Morgan Guaranty Trust Company of New York.
Manufacturers Hanover Trust Company.
Irving Trust Company.
Bankers Trust Company.
Marine Midland Grace Trust Company of New York.
United States Trust Company of New York.

Senator Anderson. Thank you very much.

Do you have any comment to make, Mr. Lindsay?

Mr. Lindsay. No comment.

Senator Anderson. Thank you. I am sorry you had to wait so long. We will recess until 10 o'clock tomorrow morning.

(Whereupon, at 12:35 p.m., the committee recessed, to reconvene at 10 a.m., Tuesday, August 9, 1966.)

FOREIGN INVESTORS TAX ACT OF 1966

TUESDAY, AUGUST 9, 1966

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

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

Present: Senators Long, Douglas, Talmadge, Williams, and Carlson.

The CHAIRMAN. This hearing will come to order.

Most of the witnesses scheduled to appear today have decided to submit statements for the record instead of appearing personally.

Others have had difficulty with air transportation, and that leaves only two witnesses to be heard today.

Our first witness is Mr. Alfred W. Barth, executive vice president of the Chase Manhattan Bank in New York.

Mr. Barth, we are happy to welcome you here today, and we will be pleased to hear your statement.

Senator CARLSON. Mr. Chairman, I would like to state that I had some difficulty with air transportation. I was supposed to speak in Boston at the National Association of Postal Supervisors at 11 o'clock. I got to the airport and the flight was canceled because they could not land at Boston this morning, so here I am at the hearing where I am happy to be.

The CHAIRMAN. After reading some of your writings on the balance-of-payments problem, Mr. Barth, I must say that I felt as though I was much better informed. I am not sure that you succeeded in informing me completely, but I am a lot better informed than I was before I read your writings.

STATEMENT OF ALFRED W. BARTH, EXECUTIVE VICE PRESIDENT, THE CHASE MANHATTAN BANK; ACCOMPANIED BY STUART E. KEEBLER, COUNSEL

Mr. BARTH. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, my name is Alfred W. Barth, I am an executive vice president of the Chase Manhattan Bank in New York. I have with me Mr. Stuart E. Keebler, counsel to my bank.

I am appearing here in my capacity as chief executive officer of the international department of that bank. While H.R. 13103 has many excellent features, I believe my deep concern over certain provisions of the proposed Foreign Investors Tax Act of 1966 is shared by many others with experience in international banking.

I understand that other witnesses have already testified before this committee in connection with the provisions of H.R. 13103 concerning income taxation of bank deposit interest earned by nonresident foreigners and estate taxation of such deposits.

My full statement has already been filed with the committee. In order to conserve the time of the committee I propose this morning to summarize the portion of my prepared statement regarding deposits. Thereafter, I would like to return to my prepared statement to invite the committee's attention to a matter involving the application of the interest equalization tax to U.S. dollar loans of foreign branches of U.S. banks.

My general conclusion as to the proposals on bank deposits is a simple one—these deposits can easily be withdrawn from U.S. tax jurisdiction, therefore escaping the tax burden, and such withdrawal undoubtedly will harm our international financial position, add to the strain on our gold stock, and hurt our domestic economy.

We are dealing with large amounts. The proposed change in tax treatment would, in our estimate, directly affect \$2 to \$2½ billion of deposits. Once these deposits are shifted to a foreign bank abroad, that bank will, in turn, almost surely lend them to foreigners. The foreign borrowers are all too likely to convert the dollars into local currency. The dollars thus will end up in the hands of foreign central banks which can turn them in to the U.S. Treasury for gold.

I know from personal conversations with customers abroad that our foreign banking competitors are already seizing upon the provisions of H.R. 13103 as a lever for encouraging the transfer of deposits to them.

I cannot forecast precisely the time and volume of deposit withdrawals, but I do feel certain that significant withdrawals will occur. I would like heartily to endorse the proposal that the provisions relating to bank deposits of nonresident foreigners not doing business in this country be deleted from the bill.

I would like now to direct your attention to the interest equalization tax matter and turn to my prepared statement starting at the bottom of page 7.

Under the terms of an Executive order issued on February 10, 1965, the interest equalization tax was extended not only to certain foreign loans made by banks in the United States, but also to loans in U.S. dollars with maturities of 1 year or more made by branches of U.S. commercial banks abroad to foreign obligors. The extension of the interest equalization tax to these foreign branch loans not only impairs the competitive position of those branches, but, at present, demonstrably works at cross-purposes to the President's overall balance-of-payments program. I understand that the Treasury Department has taken the position that this matter can only be resolved by legislation, since under the terms of the Interest Equalization Tax Act the terms of the existing Executive order cannot be appropriately relaxed.

Our foreign branches, in competition with foreign banks, have access to foreign funds in the form of Euro-dollars, or more properly called external dollars. The acquisition of these deposits already in foreign hands does not affect our balance of payments. The trouble is these potential deposits cannot at present be utilized by our branches to their best advantage—or to the best advantage of the United States.

American-owned business enterprises abroad are understandably unwilling to incur the additional cost of reimbursing our branches for the interest equalization tax on dollar loans maturing in 1 year or more. As a result, our branches are in effect prevented from making such loans to these firms, which in the normal course of events would be the prime customers of these branches. Naturally, a bank can accept deposits and pay competitive interest rates thereon only if the funds so deposited can be loaned to customers at a proper rate of return. Consequently, the effect of the interest equalization tax on foreign branch loans is to cause our foreign branches to refuse to accept certain dollar deposits from foreigners which, in the absence of tax, could be used to make term loans to the subsidiaries of U.S. businesses. My own experience is that many millions of U.S. dollar deposits from foreign sources for maturities ranging to a year or more have had to be turned down—despite the needs of U.S.-owned firms for foreign money—because of the inability to use these medium-term deposits to make loans for which there is a heavy and unfulfilled demand.

The existing exemption from interest equalization tax for foreign branch loans made in foreign currency is not of practical significance, since our branches abroad normally can attract only limited amounts of foreign currency deposits. Moreover, because of the impossibility of covering the foreign exchange risk over a series of years, it is not feasible for our foreign branches to take U.S. dollar deposits from foreigners and to convert such dollars to foreign currency for the purpose of making loans, even if the potential borrower itself is willing to borrow in a foreign currency.

As a result, U.S. subsidiaries, urged by the Government to finance their foreign operations to the maximum extent feasible from foreign sources of funds, have been forced to turn elsewhere. As you know, European capital markets are poorly developed and very congested, and indigenous foreign banks are already unable to meet fully the needs of their own domestic customers. The consequence is growing doubts over the ability of U.S. firms to complete their foreign borrowing programs.

Branches of American banks could make a significant contribution toward breaking this impasse if they are freed from the interest equalization tax. Removal of the tax would permit us to seek medium-term dollar deposits from foreigners freely in competition with indigenous banks, and to place those funds at the disposal of our borrowing customers, who are primarily U.S.-owned concerns. As a result, without any transfer of funds from the United States, the total financing available to U.S. firms abroad would undoubtedly increase, to the direct benefit of our balance of payments.

I should emphasize that removal of this tax from our foreign branches would be fully consistent with the voluntary balance-of-payments program. The Federal Reserve System, in conducting the voluntary restraint program for banks, has fully and repeatedly recognized that the loaning by our foreign branches of dollars already located abroad is not detrimental to this country. More than that, to the extent these loans enable businesses to reduce transfers from the United States, the balance of payments will be improved.

Presumably, the tax was originally extended to foreign branches to provide assurance that U.S. banks did not themselves transfer funds abroad to make loans taxable in the United States. That theoretical possibility has now been effectively closed by the fact that U.S. commercial banks can make advances to their foreign branches only within the restrictive limits of the Federal Reserve balance-of-payments guidelines. Frequent and periodic reports provide positive protection against any possible abuse.

In conclusion, I would like to express my strong approval of the proposed amendment to H.R. 13103 which was presented to the committee on August 2, 1966, amendment No. 717. The amendment to be proposed would permit the President to exempt from interest equalization tax U.S. dollar loans made at foreign branches of our banks. I understand that this proposed amendment would grant discretion to the President to reimpose the tax should he feel, contrary to all expectations, that the exemption is in any way abused. I feel confident that in view of the sizable potential benefits to the balance of payments, the President will in fact permit this exemption, and I respectfully urge that this proposed amendment be adopted.

Thank you, Mr. Chairman.

(The prepared statement of Mr. Barth follows:)

SUMMARY STATEMENT OF ALFRED W. BARTH, IN REGARD TO H.R. 13103

I. The provisions of H.R. 13103 which would impose income tax and withholding on bank deposit interest earned by foreigners not doing business in the United States (Secs. 2(a)(1) and 3(g) of the Bill) and estate tax on such deposits (Sec. 8(d) of the Bill) will have adverse consequences on the financial position of the United States, and should be deleted from the Bill.

II. Approval is expressed for a proposed amendment to H.R. 13103 which would authorize the President to exempt from Interest Equalization Tax U.S. dollar loans made at foreign branches of U.S. banks.

STATEMENT OF ALFRED W. BARTH, IN REGARD TO H.R. 13103

Mr. Chairman, members of the Committee, my name is Alfred W. Barth; I am an Executive Vice President of The Chase Manhattan Bank (N.A.) in New York. I am appearing here in my capacity as Chief Executive Officer of the International Department of that Bank, but I believe my deep concern over certain provisions of the proposed Foreign Investors Tax Act of 1966 on which I will comment is shared by many others with experience in international banking.

I would like heartily to urge that the provisions of H.R. 13103 relating to income taxation of bank deposit interest earned by nonresident foreigners and to estate taxation of such deposits be deleted from the bill, and, on the basis of my practical banking experience, to comment as to the adverse consequences which they would have on the financial position of the United States. In addition, I would like to invite the Committee's attention to a closely related matter involving the application of the Interest Equalization Tax to U.S. dollar loans by foreign branches of U.S. banks. I believe an appropriate amendment to the bill now before you would significantly facilitate the current efforts of U.S. businesses to finance their operations abroad, to the benefit of our balance-of-payments position.

Adverse consequences of taxation of bank deposits of foreigners in the United States (secs. 2(a)(1) and 3(g)) of the bill

My general conclusion as to the proposals on bank deposits is a simple one—these deposits can easily be withdrawn from U.S. tax jurisdiction, therefore escaping the tax burden, and such withdrawal undoubtedly will harm our international financial position, add to the strain on our gold stock, and hurt our domestic economy.

We are dealing with large amounts. The proposed change in tax treatment would directly affect $2 to $2½ billion of deposits. But more significant is the fact that we are dealing with an amount of funds equivalent to 15 to 18% of our entire remaining gold stock, and an amount equal to almost 50% of our remaining gold free of pledging requirements against Federal Reserve notes. Even these figures may understate the problem to the extent that shifts of these accounts may affect other banking relationships as customers move to consolidate their accounts abroad. It is important to note that the amount of deposits directly affected is as large as our entire loss of $2¼ billion of gold over the past three years.

To the extent that these foreign owned dollars (other than those owned by central banks) are held at offices of U.S. banks here and abroad they cannot be a claim on our gold. However, once these deposits are shifted to a foreign bank abroad, the foreign bank recipients of the dollar deposits will in turn almost surely lend them to foreigners. The foreign borrowers are all too likely to convert the dollars into local currency. As a result of that conversion process a good part of the additional supply of dollars so released is certain to end up in the hands of foreign central banks. The central banks, in turn, can turn them in to the U.S. Treasury for gold.

The effect of the proposed tax will be artificially to stimulate the growth of the Eurodollar market at the expense of the dollar deposit accounts now maintained by foreigners with U.S. banks. In other words, the tax will stimulate the shift of deposits to foreign banks abroad. Once this occurs there is no way to prevent conversion of the dollars to foreign currency and the possible call on our gold which can result when the dollars come into the hands of foreign central banks.

A bank executive responsible for extensive day-to-day international operations, I am made aware continually that U.S. banks no longer are in a unique position to compete for dollar deposits of foreigners. My foreign competitors in important financial centers throughout the world are ready, willing and able to compete for this business. The force of their competition is illustrated by the fact that banks in ten leading foreign countries at the end of 1965 already held some $11¾ billion of gross dollar deposits from non-Americans who were not resident in the country of deposit. That total is already several times the volume of time deposits of foreigners in the United States.

Included among these foreign banks are the foreign branches of U.S. banks. To the extent these branches of U.S. banks recapture the funds shifted from the U.S. the damage will be minimized, for these funds are likely to be transferred back to this country or to be employed in lending to subsidiaries of U.S. companies, indirectly helping the balance of payments. But, of course, these branches only account for a fraction of the total, and we can certainly not count on deposits shifted from the U.S. being transferred to those branches. I would hope some of them would be, but, from the standpoint of the national interest, the objective should be to encourage rather than discourage the retention of existing deposits within the United States. I should also point out that, in many instances, foreign banks already benefit from some competitive advantages, such as more liberal regulatory treatment.

I am not aware that anyone familiar with international banking contests the conclusion that the proposed taxation will tend to drive the deposits abroad. The Committee on Ways and Means of the House of Representatives itself pointed out in its report on H.R. 13103 that immediate income taxation of bank interest could have "a substantial adverse effect on our balance of payments."

The postponement of the effect of the income and withholding tax until after 1971 will not solve the problem since it fails to recognize the sensitivity of foreign depositors to the kind of strong expression of Congressional intent embodied in the bill. I know from personal conversations with customers abroad since the House action that our foreign banking competitors are already seizing upon these new provisions of the bill as a lever for encouraging the transfer of deposits to them. In particular, they are pointing out to our foreign depositors the desirability of acting promptly to establish and solidify new banking relationships abroad well in advance of the effective date. In the process, the foreign banks naturally have no incentive to emphasize that the proposed income tax effective date is some distance off. Confusion on that point will tend to accelerate transfers, and inevitably some of our foreign customers will interpret the action, whatever its effective date, as a harbinger of a less hospitable climate for these funds in the United States. The application of the estate tax without delay means, of course, that individual depositors have every incentive to move their funds promptly.

Naturally, in response to urgent inquiries from foreign depositors contemplating an early transfer, we are doing what we can to dispel confusion and maintain these relationships, but I fear that, if the Senate supports the House action, our success in this effort is not assured, to say the least. I should also note, in this connection, that our analysis of our own deposit composition offers little or no basis for a belief that tax treaties or foreign tax credits abroad will substantially ease the impact.

I cannot forecast precisely the time and the volume of deposit withdrawals. But I do feel certain that significant withdrawals will occur. The situation presented would be analogous to, say, an attempt by one of our states to extend its income tax to interest paid on nonresident bank deposits. The banks in that state would simply lose those deposits. But, of course, the impact of this tax is worse since the consequences are international and not solely internal. The adoption of these provisions would have most unfortunate and unnecessary repercussions on our international gold position, on the position of the United States as a world financial center, and even on our internal economy.

The Interest Equalization Tax Act should be amended by H.R. 13103 to authorize the President to exempt dollar loans made at foreign branches of U.S. banks

I would like now to turn to an important Interest Equalization Tax matter, which I believe should appropriately be changed by an amendment to H.R. 13103.

Under the terms of an Executive Order issued on February 10, 1965, the Interest Equalization Tax was extended not only to certain foreign loans made by banks in the U.S., but also to loans in U.S. dollars with maturities of one year or more made by branches of U.S. commercial banks abroad to foreign obligors. The extension of the Interest Equalization Tax to these foreign branch loans not only impairs the competitive position of those branches, but at present demonstrably works at cross purposes to the President's over-all balance-of-payments program. I understand that the Treasury Department has taken the position that this matter can only be resolved by legislation, since under the the terms of the Interest Equalization Tax Act the terms of the existing Executive Order cannot be appropriately relaxed.

Our foreign branches, in competition with foreign banks, have access to foreign funds in the form of Euro-dollars. The acquisition of these deposits *already in foreign hands* does not affect our balance of payments. The trouble is these potential deposits cannot at present be utilized by our branches to their best advantage—or to the best advantage of the United States.

American-owned business enterprises abroad are understandably unwilling to incur the additional cost of reimbursing our branches for the Interest Equalization Tax on dollar loans maturing in one year or more. As a result, our branches are in effect prevented from making such loans to these firms, which in the normal course of events would be the prime customers of these branches. Naturally, a bank can accept deposits and pay competitive interest rates thereon only if the funds so deposited can be loaned to customers at a proper rate of return. Consequently, the effect of the Interest Equalization Tax on foreign branch loans is to cause our foreign branches to refuse to accept certain dollar deposits from foreigners which, in the absence of tax, could be used to make term loans to the subsidiaries of U.S. businesses. My own experience is that many millions of U.S. dollar deposits from foreign sources for maturities ranging to a year or more have had to be turned down—despite the needs of U.S.-owned firms for foreign money—because of the inability to use these medium-term deposits to make loans for which there is a heavy and unfulfilled demand.

The existing exemption from Interest Equalization Tax for foreign branch loans made in foreign currency is not of practical significance since our branches abroad normally can attract only limited amounts of foreign currency deposits. Moreover, because of the impossibility of covering the foreign exchange risk over a series of years, it is not feasible for our foreign branches to take U.S. dollar deposits from foreigners and to convert such dollars to foreign currency for the purpose of making loans, even if the potential borrower itself is willing to borrow in a foreign currency.

As a result, U.S. subsidiaries, urged by the Government to finance their foreign operations to the maximum extent feasible from foreign sources of funds, have been forced to turn elsewhere. As you know, European capital markets are poorly developed and very congested, and indigenous foreign banks are already unable to meet fully the needs of their own domestic customers. The consequence is growing doubts over the ability of U.S. firms to complete their foreign borrowing programs.

Branches of American banks could make a significant contribution toward breaking this impasse if they are freed from the Interest Equalization Tax.

Removal of the tax would permit us to seek medium-term dollar deposits from foreigners freely in competition with indigenous banks, and to place those funds at the disposal of our borrowing customers, who are primarily U.S.-owned concerns. As a result, without any transfer of funds from the U.S., the total financing available to U.S. firms abroad would undoubtedly increase, to the direct benefit of our balance of payments.

I should emphasize that removal of this tax from our foreign branches would be fully consistent with the voluntary balance-of-payments program. The Federal Reserve System in conducting the voluntary restraint program for banks has fully and repeatedly recognized that the loaning by our foreign branches of dollars already located abroad is not detrimental to this country. More than that, to the extent these loans enable businesses to reduce transfers from the U.S., the balance of payments will be improved.

Presumably, the tax was originally extended to foreign branches to provide assurance that U.S. banks did not themselves transfer funds abroad to make loans taxable in the U.S. That theoretical possibility has now been effectively closed by the fact that U.S. commercial banks can make advances to their foreign branches only within the restrictive limits of the Federal Reserve balance-of-payments guidelines. Frequent and periodic reports provide positive protection against any possible abuse.

In conclusion, I would like to express my strong approval of the proposed amendment to H.R. 13103 which was presented to the Committee on August 2, 1966.[1] The amendment to be proposed would permit the President to exempt from Interest Equalization Tax U.S. dollar loans made at foreign branches of our banks. I understand that this proposed amendment would grant discretion to the President to reimburse the tax should he feel, contrary to all expectations, that the exemption is in any way abused. I feel confident that in view of the sizable potential benefits to the balance of payments, the President will in fact permit this exemption, and I respectfully urge that this proposed amendment be adopted.

Thank you, Mr. Chairman.

The CHAIRMAN. Let me just ask you this: If we give you this exemption you are asking for here, Mr. Barth, is there something in such an amendment to keep you from transferring money overseas from your parent bank into the branch and then lending it out from the foreign branch bank?

Mr. BARTH. Mr. Chairman, the transfer of money from here to the branch is controlled under the guidelines. We have to make a monthly report to the Federal Reserve Board, the Board of Governors of the Federal Reserve, and it is within our present 107 or 108 percent. We cannot exceed that.

The CHAIRMAN. So, if I understand your argument on this, you contend that if you are not permitted through your foreign branches to lend the dollars that come into those branches in those European areas, then those dollars are simply not going to come into those branches, for the most part. They will go to someone else's bank, rather than go to your branches.

Mr. BARTH. That is right.

The CHAIRMAN. And banks of other nations will loan it out.

Mr. BARTH. And they will loan it out.

The CHAIRMAN. So that in the last analysis about all that the restriction on your branches is doing is just taking business away from American branches——

Mr. BARTH. And giving it to foreign banks.

The CHAIRMAN (continuing). And putting it in foreign banks where this country has no say about what happens to those same dollars.

Mr. BARTH. That is correct.

---

[1] Amendment No. 717.

The CHAIRMAN. That term Euro-dollars is a term I had not used a lot. You are talking about American dollars in Europe that are used as American dollars over there?

Mr. BARTH. Euro-dollars is a name that was adopted in the late forties when the Russian bank in Paris started to keep its dollar deposits outside of the United States, and the word "Euro-dollars" really came from the cable address of the Russian bank in Paris, and the cable address is Eurobank. I think a more correct description of Euro-dollars would be to say external dollars, dollars which are outside of the jurisdiction of the United States.

The CHAIRMAN. Are those paper dollars and coins or part of them just credits that somebody writes down on a sheet of paper? In other words, I am beginning to learn enough about banking to know that many times what you talk about as dollars is just a number that you write down on one of those ledger sheets in your bank. Does having that many dollars abroad mean that somebody actually has that many dollars in terms of paper ones and paper one hundreds out or does it mean that they have that many dollars overseas in terms of simply credits?

Mr. BARTH. Well, Mr. Chairman, the size of the so-called Euro-dollar market according to estimates made by my bank and by the Bank for International Settlements at Basle, the gross dollar deposits in 10 major countries of nonresidents and non-Americans went from $7 billion in 1963 to $11,750 million in 1965.

The CHAIRMAN. So those are dollars—let me get this straight in my mind now. That is $11 billion?

Mr. BARTH. That is right.

The CHAIRMAN. That is in 10 major countries overseas. Does that include Japan or just European countries?

Mr. BARTH. This will include Japan, because Japan is a big user of Euro-dollars in the London market.

The CHAIRMAN. Yes.

So $11 billion held by non-U.S. citizens, citizens of countries other than the United States, citizens of Japan and nine European countries, dollars which could be converted into gold claims in the event that they were taken into the central banks of those countries.

Mr. BARTH. That is absolutely right.

The CHAIRMAN. I take it that it is to our advantage, however, that they continue to be used as dollars rather than going into the central bank?

Mr. BARTH. I should think so, Mr. Chairman.

The CHAIRMAN. Now, those countries do have the power to call all those dollars into the central banks, do they not?

Mr. BARTH. I do not believe that all countries have, because in Germany, Switzerland, Holland, and Belgium, I believe you have great freedom in foreign exchange, no foreign exchange restrictions, and I believe for the central banks to call these dollars in they would have to have legislation, but that could be arranged.

The CHAIRMAN. Yes. It would take legislation. It would probably be complicated to administer, but most of that they can call into their central banks.

Of course, Switzerland would have to drastically change its banking practices to do that, I take it, because they have all sorts of ways of doing business in Switzerland where you just do not know who has the money; is not that about the size of it? The bankers know it, but they do not require the banker to tell the Government.

Mr. BARTH. Well, Mr. Chairman, your question is very difficult to answer in this particular case. Obviously, all governments have the right to ask their citizens to turn in the dollars to the central bank if they want to do that. But I do not think anything would be accomplished out of that.

The CHAIRMAN. In other words, it could be done, but you do not think it will be done by any of these governments.

Mr. BARTH. It could be done, but I do not think it will be done.

The CHAIRMAN. And, if I understand the burden of your argument, it is that the way the law applies to your foreign branches creates an impact that you doubt we considered when we passed that legislation because it tends to run these U.S. dollars that exist in these European countries and in Japan into other people's banks rather than to let them come into the branches of American banks.

Mr. BARTH. Well, far be it from me to say that the law did not get the proper consideration, but I believe conditions have changed since, and the Euro-dollar has become much more important in not only international but American banking business since 1964, and most American banks with branches abroad have drawn upon their deposits generated by the London office to feed New York, so that New York could make loans to aid the domestic economy; and, obviously, if we are not competitive in quoting interest rates in London as compared to British or French or Japanese or other banks, we will not get these dollars, not only to aid American subsidiaries abroad, but to aid ourselves.

The CHAIRMAN. I recall very well how we voted the amendment to give the President the power to extend the interest equalization tax to bank loans. It occurred the same night that the President made the decision to strike back at the North Vietnamese in the Gulf of Tonkin, which was a rather important occasion. Most of the Senators were down there at the White House talking with the President about the situation in Vietnam while we were debating the interest equalization tax problem.

I do not think their vote would have been any different, but the argument had been made for days that the interest equalization tax was a fraud, and that it was just a gesture, it would not succeed because anybody could evade the interest equalization tax by going through bank loans. After that argument had been made for awhile, some of us who had been hearing the argument began to say if that is the case why don't we just close that loophole and say that in the event that that device is used, then the President would extend the tax to cover bank loans.

But, the problem you are presenting here, Mr. Barth, was never discussed at all. I do not think it was discussed.

Mr. BARTH. If you will permit me, Mr. Chairman, I would like to give you another example.

The CHAIRMAN. Yes.

Mr. BARTH. There are many American concerns that have gone into the London Euro-dollar market to float debentures, either straight debentures or convertible debentures, and these debentures are for 10, 15, 18 years.

The financial houses selling these debentures are using the very same dollars that I propose to use to make loans of a lesser duration, and the American subsidiary abroad does not like to be obligated to pay a high rate of interest ad infinitum for 15 or 20 years because it really does not need the money for 15 or 20 years. But we are stopped from helping it for 3, 4, or 5 years, which is really the requirement that it had, because of the interest equalization tax, and yet we are using the same dollars.

The CHAIRMAN. So you would be able to give better treatment to Americans doing business overseas through American branch banks overseas——

Mr. BARTH. That is right.

The CHAIRMAN. If you were not foreclosed from doing this.

Mr. BARTH. That is right.

The CHAIRMAN. And it would be better for the American business interests and, of course, it would be better for your bank because you like to do business with those Americans over there.

Mr. BARTH. We like to pay taxes, too.

The CHAIRMAN. Are you sure about that now, Mr. Barth?

Mr. BARTH. Yes, sir. The more business we do the more we can pay.

The CHAIRMAN. Thanks so much.

Senator Williams.

Senator WILLIAMS. In the foreign branches are you allowed to hold gold?

Mr. BARTH. I beg your pardon?

Senator WILLIAMS. Can you hold gold in your reserves in your foreign branches?

Mr. BARTH. In the foreign branches we do not; no. We are not allowed by law, but there are certain exceptions made. For instance, we have an affiliated bank in Peru, and they have for years and years and years put their reserves in gold, and we have a license from the Treasury Department to continue that.

Then there is another exception in the Persian Gulf where banks are permitted to trade in gold, also under license of the Treasury, but not for their own account.

Senator WILLIAMS. I did not understand.

Mr. BARTH. They are not allowed to trade in gold for their own account. They are only allowed to finance the trading of gold.

Senator WILLIAMS. And, as I understand it, through your branch banks you would not be allowed to arrange a program where you could convert any of these dollars into gold if you wished.

Mr. BARTH. No, no; because the gold regulations of the Treasury Department do not apply only in the United States. They touch every American or every American corporation wherever they are.

Senator WILLIAMS. That was my understanding.

Are you permitted in your investment portfolio abroad to buy these bonds that the Treasury is issuing in the foreign countries that are payable in marks or francs or whatever they may be?

Mr. BARTH. In our investment portfolio abroad or here?

Senator WILLIAMS. Abroad. I know you are not here.

Mr. BARTH. Abroad in Germany we will buy some German mark bonds, yes. In France we have to buy French. In Britain we have to buy British for reserve requirements or capital requirements.

Senator WILLIAMS. I did not quite mean that.

The Treasury, in order to stop the conversion of dollars into gold, has done some of its financing by borrowing the money, that is, our Government, the U.S. Government, has borrowed, this money abroad, payable in the respective currency of the country over there and, of course, that currency is more or less pegged to the $35 gold.

Are you permitted to buy that type of a security through your branches? It is not available to American citizens, I understand.

Mr. BARTH. Are we permitted to buy bonds in a foreign currency?

Senator WILLIAMS. The Government, the U.S. Government obligations which are issued abroad payable in the currency of their respective countries.

Mr. BARTH. Senator, I believe you are referring to the Roosa bonds. We do not. We are not buying those.

Senator WILLIAMS. You are not permitted to buy them?

Mr. BARTH. No.

Senator DOUGLAS (presiding). Senator Talmadge.

Senator TALMADGE. Mr. Barth, you state on page 2 of your prepared statement dealing with taxation of bank deposits of foreigners that the proposed change in tax treatment would directly affect $2 to $2½ billion of deposits.

Mr. BARTH. Yes, sir.

Senator TALMADGE. Now, are those the deposits only in State and national banks or does that also include total deposits in State and national banks, mutual savings banks, and the savings and loan associations?

Mr. BARTH. Senator, as of—I have the official statistics of the Federal Reserve Bulletin of May 1966, and this $2 to $2½ billion is made up as follows:

Unfortunately it is not the deposits only with the Chase Manhattan Bank. These are the deposits in the United States. Time deposits of nonofficial, nonbank foreigners, $1,633 million; time deposits of foreign commercial banks, $740 million; CD's, Certificates of Deposit, of nonofficial, nonbank foreigners, $100 million; and demand and time deposits subject to possible estate tax proposals estimated at $150 million; which makes a total of $2,473 million. This does not include deposits with savings banks or savings and loan associations, as there may be some.

Senator TALMADGE. Would you have any idea how much the total would be in those two instances?

Mr. BARTH. I am sorry I do not have that figure.

Senator TALMADGE. Would it be a considerable amount or would it be inconsequential?

Mr. BARTH. I should think that among the border States it may be considerable.

Senator TALMADGE. Well, then, that would add to the $2½ billion that you mentioned in your statement.

Mr. BARTH. Yes, sir.

Senator TALMADGE. And would add to the total possible flight of dollars in the American market.

Mr. BARTH. It could well, yes, sir.

Senator TALMADGE. Do you have any idea how much of this money might be transferred in the event it was to be taxed immediately under the terms of this bill?

Mr. BARTH. This is very difficult to estimate, but I can tell you of my own experience during the past 2 months, that I have lost two clients to European banks because of the impending legislation.

Senator TALMADGE. In your case you could simply let that customer transfer his deposits in New York to the Paris bank, without losing his deposit?

Mr. BARTH. No. Unfortunately this went to a bank, a commercial bank, in another country.

Senator TALMADGE. But it could have been withdrawn from your bank and deposited in your branch bank in Paris, could it not?

Mr. BARTH. It could have, yes.

Senator TALMADGE. However, banks without branch banks such as yours would not have that advantage.

Mr. BARTH. That is right, sir.

Senator TALMADGE. Are bank deposits highly mobile in their nature; do they seek the highest return at the immediate moment?

Mr. BARTH. They are very mobile because they seek higher return and they change, particularly in the external dollar market they change, for a fraction of a percentage point.

Senator TALMADGE. Let us take a mythical account now. Assume some foreigner has $1 million on deposit in your principal bank in New York, and at present you pay him 5½ percent.

Mr. BARTH. That is the maximum extent allowed.

Senator TALMADGE. That would give him an income of $55,000 annually on his $1 million deposit, would it not?

Mr. BARTH. Yes, sir.

Senator TALMADGE. Under the terms of this act as passed by the House, if it is adopted, he would pay in 1972, $16,500 in withholding taxes on that $55,000, would he not?

Mr. BARTH. That is right.

Senator TALMADGE. Assume that he decides to avoid that tax. Could he take that $1 million and transfer it to a bank in Paris?

Mr. BARTH. Senator, are you speaking about an American citizen or——

Senator TALMADGE. A foreign citizen, because this is not applicable to Americans, since it only applies to foreigners.

Mr. BARTH. A foreign citizen will most likely move the money out of here.

Senator TALMADGE. Then he could take his $1 million out of your bank in New York and put it in a Paris bank, could he not?

Mr. BARTH. A foreign citizen could; yes.

Senator TALMADGE. What would he get on his certificate of deposit in the foreign bank?

Mr. BARTH. We do not issue certificates of deposit in Paris.

Senator TALMADGE. But do other banks do so?

Mr. BARTH. Not in Paris. Certificates of deposit so far have only been issued in London.

Senator TALMADGE. Well, what could he do, assuming he wants the highest return he could get, to avoid the tax, assuming he was financially wise?

Mr. BARTH. Are we again talking about $1 million for 1 year?

Senator TALMADGE. Using the $1 million as a practical example because you can easily figure the interest on it, and what it amounts to.

Mr. BARTH. That is right. Well, he could go to a British bank, he could go to a Swiss bank, he could go to other banks.

Senator TALMADGE. Assuming he desires to transfer it to London, what would his interest rate be there?

Mr. BARTH. He could do that in London and with a foreign bank, not an American bank, he could probably get today, instead of 5½ percent, he probably could get for 1-year money close to 7¼ percent, whereas he would not get this from an American bank operating in London.

Senator TALMADGE. That would be $72,500, he could earn on his money for 1 year.

Mr. BARTH. That is right.

Senator TALMADGE. Would that be tax free?

Mr. BARTH. This would be tax free; yes, sir.

Senator TALMADGE. In other words, if he started off with $55,000 in income, he would be subject to the American tax of $16,500. But by switching his business to a foreign bank in London he could have an income of $72,000; is that correct?

Mr. BARTH. That is about right under today's interest rates.

Senator TALMADGE. Is that the reason why you state that a substantial portion of this $2½ billion might leave the American banks?

Mr. BARTH. Yes, sir.

Senator DOUGLAS. Will the Senator yield?

Senator TALMADGE. Certainly, I am delighted to yield.

Senator DOUGLAS. Mr. Barth, do these foreign countries have income taxes?

Mr. BARTH. They do have. Based upon information we have been able to obtain, the return is not taxable for a nonresident in France nor in Germany. There is no withholding and, in practical effect, no tax in the United Kingdom; Italy and Canada—where in other than Canadian dollars—in Switzerland and Japan interest is taxable.

Senator DOUGLAS. It is taxable?

Mr. BARTH. Yes; in Switzerland, but it is not in London.

Senator DOUGLAS. Would the same provisions apply for foreign depositors as for domestic depositors?

Mr. BARTH. These are for foreign depositors, Senator.

Senator DOUGLAS. Pardon?

Mr. BARTH. These are for foreign depositors.

Senator DOUGLAS. For foreign.

Do you know the rates of taxation in Switzerland and Japan? Aren't they quite heavy?

Mr. BARTH. I believe in Switzerland the withholding tax on interest earned by nonresidents is 27 percent. In Japan I am not certain, but I believe it is 20 percent.

Senator DOUGLAS. You say, however, in England this is not taxable.

Mr. BARTH. No, sir.

Senator DOUGLAS. Is the income of the individual taxable so that while there would not be withholding at the source there would be taxation of the individual, of the recipient?

Mr. BARTH. To the best of my knowledge, if a nonresident of England has an account in England, the interest is not taxable.

Senator DOUGLAS. I wonder if you would consult your legal department on that.

Mr. BARTH. We have.

Senator DOUGLAS. You have?

Mr. BARTH. We have. It is rather a little confusing. I believe the legal department informed us that there are laws on the books but they apparently are not taxing nonresidents, nor withholding tax, and no tax.

Senator DOUGLAS. I did hear the first part of your statement.

Mr. BARTH. Our legal department informed us that the British situation is a little confusing. There are certain laws on the books, but apparently they are not being enforced as far as nonresidents are concerned.

Senator DOUGLAS. That is very unusual for the British not to enforce their laws. They are, on the whole, the most law-abiding people that we have, and laws which are on the books tend to be enforced.

What about France, where the chief danger for the gold run may come?

Mr. BARTH. Not taxable.

Senator DOUGLAS. Not taxable in France.

What did you say about Italy?

Mr. BARTH. No withholding tax in Italy for nonresident aliens.

Senator DOUGLAS. What about the low countries, Belgium and Holland?

Mr. BARTH. I do not have this information here, but, Senator Douglas, if you would like to have it, I would be glad to have our legal department write a memorandum.

Senator DOUGLAS. Do you have any material on the Scandinavian countries?

Mr. BARTH. No. The Scandinavian countries do not enter into this particular aspect because the Scandinavian countries borrow more than—there are very few foreign deposits in Scandinavian countries.

Senator DOUGLAS. Let me put it this way: While the situation is mixed, is it not true in some cases if the depositors abroad withdrew their funds, they would be jumping from the frying pan into the fire?

Mr. BARTH. Well, I do not know how to answer that. People still have a lot of faith in foreign banks, particularly in London, and some European countries; and whether or not your statement is correct, I am not here—I cannot answer it.

Senator DOUGLAS. Well, it would not seem at the moment that there would be great alacrity on the part of foreign depositors to deposit in British banks. On the contrary, the movement is the other way, unfortunately.

Mr. BARTH. Well, when I say deposit in British banks, Senator, I mean deposit dollars in British banks, not the conversion into pounds, and the British banks have an awful lot of dollar deposits in the so-called external dollar deposits.

Senator DOUGLAS. Which they will not exchange into pounds.

Mr. BARTH. Oh, no, no. They are used in dollars to finance world trade, to finance modernization of factories, to finance all kinds of things not necessarily in Britain but worldwide.

Senator WILLIAMS. If there were a devaluation, those dollars deposited in the British banks would not be affected at all?

Mr. BARTH. Oh, no, no. You see, one of the strengths of the London market has been that even though you had devaluations and foreign exchange restrictions for the British, foreign currency deposits by nonresidents in London banks have never been affected. That is the strength of the London market.

Senator DOUGLAS. Senator Carlson.

Senator CARLSON. Mr. Barth, just one or two questions. I was interested in what I believed to be the substantial increase, I think you said in 1963 there were between seven and seven point something billion; and in 1965 or 1966 it is $11 billion. What is responsible for this great increase in these 2 or 3 years?

Mr. BARTH. Well, I suppose the proper answer to your question is that the increase represents an increase of dollars held outside of the jurisdiction of the United States. In other words, they have not been permitted to come back as American dollars, and these $11,750 million are outside of the jurisdiction of the United States today.

Senator CARLSON. Well, I assume that this, which would be, approximately $4 billion in the last 3 years, which is a substantial movement of dollars, have they gone over for investment purposes and because interest rates are higher? Have they gone over——

Mr. BARTH. Well, the obvious reason is, when I say it is not subject to the jurisdiction of the United States, the European banks are not subject to the jurisdiction of regulation Q, and I will give you an example of what money market rates are in London today. I am speaking of dollars.

Senator CARLSON. That is right.

Mr. BARTH. It may interest you to hear this. Call money, that is, sight deposit, 5¾ percent; 7-day fixed, 6⅛; 1 month, 6½; 2 months, 6⅜ percent; 3 months, 6$\frac{7}{16}$; 6 months, 6$\frac{13}{16}$; and 12 months, 7¼ to 7⅜, compared to your maximum here of 5½.

Senator CARLSON. In other words, our citizens just show they have good business acumen, and put their money where they can get good interest and good rates.

Mr. BARTH. Well, Senator, I believe no branch bank of an American bank will accept abroad a dollar deposit from a citizen of the United States except if he is a resident of London. We would not accept an account from any citizen of the United States who is a resident in the United States, either in London or Paris or Beirut. We have an understanding along those lines with the Federal Reserve Bank.

Senator CARLSON. That is what I was going to get to next. You state in your statement, you say, "The U.S. commercial banks can make advances to their foreign branches only within the restrictive limits of the Federal Reserve balance-of-payments guideline." As a member of the committee you would help me if you would tell me what are some of those restrictions.

Mr. BARTH. Well, that means that we cannot transfer money to London to let London loan the money to foreign individuals. What we propose is to let London generate its own deposits to make these loans.

Senator CARLSON. In other words, these restrictions then evidently are not too effective, are they?

Mr. BARTH. They are very, very effective.

Senator CARLSON. You say they are very effective?

Mr. BARTH. Yes.

Senator CARLSON. Well, I was just interested in what is happening to our dollars, and I am also cognizant of the balance-of-payments problem, and we are all concerned about that. I appreciate very much your responses.

Senator WILLIAMS. Primarily from where did this $4 billion come from; out of what was it generated?

Mr. BARTH. Yes. The $4 billion increase presumably comes from, in the main, from foreign banks that want to utilize the—foreign banks and individuals that want to utilize—their dollars in investments outside of the United States at a higher return.

Senator WILLIAMS. I understand that. But if we had about $7 billion in that category in 1963 and it increased to $11 billion——

Mr. BARTH. That is right.

Senator WILLIAMS (continuing). What is the primary source of it? It just does not grow——

Mr. BARTH. Well, the increase in the money supply between 1963 and 1965 has something to do with that, and I believe this almost matches the increase in the money supply.

Senator WILLIAMS. How does it get out of this country to get over there in the AID programs and various other programs?

Mr. BARTH. Well, to answer your question, let me finish answering your first question. I believe the U.S. balance-of-payments deficit has something to do with the increase.

Senator WILLIAMS. That is what I was getting at.

Mr. BARTH. I should have answered that before.

The CHAIRMAN (presiding). Senator Talmadge.

Senator TALMADGE. Thank you, Mr. Chairman.

Mr. Barth, as I understand it, this bill is designed to provide equitable tax treatment for foreign investments in the United States, and to particularly try to correct the balance-of-payments deficit. Do you believe in its present form it will aid in correcting the balance of payments or will it worsen it?

Mr. BARTH. In its present form?

Senator TALMADGE. Yes, sir.

Mr. BARTH. In its present form I cannot help but say that I believe it will worsen it.

Senator TALMADGE. Do you consider a gold drain in the dollar deficit at the present time a very serious problem affecting our country?

Mr. BARTH. Yes, I consider this a very serious problem.

Senator TALMADGE. If you had a completely free hand to correct the gold drain, what corrective measures would you take?

Mr. BARTH. Well, if I had a completely free hand I would consider that the banking fraternity as such has reduced the balance-of-payments outgo considerably; business has also done so, and I would believe that we could help our balance-of-payments deficit considerably if we would permit the opulent and affluent society of Western Europe to kind of look out for themselves, and to bring some of our troops back, reduce some of the expenses.

Senator TALMADGE. I have heard various reports from a very senior member of the Appropriations Committee that our six divisions in Western Europe caused a dollar deficit of $2½ billion, but the Secretary of the Treasury testified when he was before this committee that it contributed a dollar deficit in the amount of $750 million. I think that if some arrangements whereby Germany would buy certain arms from us this would have some countereffect on the $2½ billion. Do you have any idea how much our troop maintenance at the present time contributes to our true dollar deficit?

Mr. BARTH. I have no accurate knowledge. But last week, while I was down in Washington, I heard that our sales of dollars to Germany alone, I believe, is in the neighborhood of $1.1 billion to $1.2 billion annually.

Senator TALMADGE. All right, we agree if some of the troops are brought home this would cut down on the dollar deficit. What else would you do?

Mr. BARTH. Right now, in addition to that, I think the most important thing for us to do would be to stimulate exports more.

Senator TALMADGE. How would you proceed to do that?

Mr. BARTH. I would try to induce the Export-Import Bank to become an insurer rather than a lender.

Senator TALMADGE. Has any proposal along that line been recommended to Congress?

Mr. BARTH. Well, I believe it has been talked about for 1 or 2 years, but you will have heard from Chairman Linder, quite properly, that under the law the Export-Import Bank is authorized to make collectible loans, and, therefore, the head of the Export-Import Bank must, as such, see to it that the loans are collected.

Senator TALMADGE. What countries operate by insuring rather than lending?

Mr. BARTH. In most countries it is on an insurance basis. It is quicker and less troublesome.

Senator TALMADGE. What else would you do besides that? What do you think about foreign aid? How much does that contribute to our dollar deficit?

Mr. BARTH. Well, I think wiser men than myself have been talking about foreign aid down here for quite some time, and I would like to beg off that.

Senator TALMADGE. How about tourists?

Mr. BARTH. Well, we seem to have an insatiable appetite to see the world. Britain had to cut down. But, you notice, Britain only cut it as of November 1, when summer is over. It seems to be difficult to legislate against people and their desires to travel. But the outflow from tourism is terrific.

Senator TALMADGE. What is the true dollar deficit on tourism, about $2 billion annually?

Mr. BARTH. I believe it is about between $1.7 billion and $2 billion.

Senator TALMADGE. Thank you, Mr. Barth. I think you have been one of the most knowledgeable witnesses I have seen before this committee since I have had the privilege of sitting on it.

Mr. BARTH. Thank you very much, sir.

The CHAIRMAN. Mr. Barth, if we are going to reduce the outgo through tourism, it seems to me we can do several things. Of course, one is to advertise; we are doing some of that; advertise the American sights better to encourage people to see more things over here. But if we are going to increase tourism, it seems to me we must do a couple of other things: We have either got to raise the cost of American tourism abroad by putting taxes on passports or some such thing as that so as to make it cost Americans more to go overseas or else we must subsidize the citizens of foreign countries moving to the United States to see what we have. I just wondered what thoughts you might be able to offer on that subject, as just a businessman who is worried about banking problems but sees how this cash moves.

Mr. BARTH. Mr. Chairman, you have just given me an idea. I am not prepared to explore it here. But, you know, you have counterpart funds all over the world. You have none in Western Europe today. But, perhaps, some thought ought to be given to the creation of some counterpart funds so that the people in spending—instead of spending dollars which are redeemable at the Bank of France or the Bundesbank, that they will be redeemable against the fund which belongs either to the Treasury Department or somebody else, and I would like to make a study of this, and I will submit a report to you.

The CHAIRMAN. You say you might create some sort of counterpart fund. Would you mind explaining that again?

Mr. BARTH. Well, let us say if France wants to have our tourists they ought to put some French francs at the disposal of this fund which ultimately could be used only to buy American goods; in other words, to compensate for it. But I would like to think that out a little more.

The CHAIRMAN. I would appreciate it if you would just give us your thoughts along that line, because somewhere along the line I think we are going to——

Mr. BARTH. For instance, I do not understand why any American—I am speaking about private people going to places like India or Pakistan or wherever we have counterpart funds—why they should be allowed to spend any dollars. He should buy the counterpart funds from somebody here before he goes, and spend them freely, and leave the dollars here in the United States.

The CHAIRMAN. Then that being the case, I take it, they would have that available to them to spend in the United States, to buy American products with.

Mr. BARTH. No. Their counterpart funds, Mr. Chairman, belong to you, the Government of the United States, and the dollars that the American tourist would spend abroad will be paid to the Government of the United States.

For instance, you have $1.5 billion worth of rupees. Came the devaluation and you lost $400 million.

The CHAIRMAN. Would you mind giving me that again, because that is something that really merits consideration. You said that we had $1.5 billion in rupees——

Mr. BARTH. That is right.

The CHAIRMAN. Available to us in India.

Mr. BARTH. Isolated, they are isolated in India because you are not allowed to use them without the consent of the Indian Government. Then, in addition to that, you have Public Law 480 rupees.

The CHAIRMAN. You said though in the exchange, in the currency exchange, we lost $400 million.

Mr. BARTH. When the rupee was devalued 2, 3, 4 weeks ago by 36.5 percent you lost the equivalent of $400 million.

The CHAIRMAN. So we lost the equivalent of $400 million, did you say?

Mr. BARTH. Yes. The rupee was devalued against the dollar by 36.5 percent.

The CHAIRMAN. I would appreciate it if you would just give us your thoughts which you have along that line. Frankly, it does occur to me that the way we are accepting these foreign currencies, at least we ought to try to make the maximum use possible of them rather than have them simply pinned down in those countries where we cannot do anything with them, except to use them in a way that those countries tell us we can use it. If they tell us we cannot use it at all, it just means we might as well not have it over there, because we cannot use it, we cannot do anything with it.

Mr. BARTH. That is right.

Senator WILLIAMS. The expansion of the foreign tourism in this country has been something that we have been working on for quite a while, but is it not getting a setback with this airline strike because we are getting some complaints—I have had a few in my office—of foreign visitors over here who cannot complete the tour for which they were booked? I was wondering what impact you think that this airline strike may be having on our balance of payments or our economy in general by having to use the foreign airlines for transportation.

Mr. BARTH. Well, you know that stranded Americans are estimated to be somewhere between 25,000 and 30,000 in Western Europe alone, and they have to find ways and means of getting home.

I know of several of them who left Rome to go to Madrid feeling that they could come here more readily. From Madrid they went to London, and now they were assured of passage back to the United States around August 28 or 29, on a foreign airline.

Now, if you add this up, multiply that by 30,000, and also figure out what each American spends abroad just to live, it certainly has an impact on our balance of payments.

Senator WILLIAMS. Thank you.

Would you care to comment also on what impact you think it is having on our domestic economy?

Mr. BARTH. Well, I have gone through the airport here in Washington this morning or last night; I was here last Wednesday, and I saw the LaGuardia Airport, and it is half empty. I feel very sorry for the people who have the stores and restaurants in there and obviously all you have to do is talk to a cab driver who drives out to the airport and he will tell you his story, too.

Senator WILLIAMS. Thank you.

Senator DOUGLAS. Mr. Chairman, I would like to make a request of the Treasury—is there a representative of the Treasury here—I would like to ask that the Treasury prepare a comparative statement on the rates of taxation of deposits by foreigners and citizens in the banks of various countries so as to get a comparison of the comparative advantages and disadvantages in taxation matters which these various countries have, and, as the Senator from Georgia suggests, not merely including withholding on current income but inheritance taxes as well.

(Pursuant to the above discussion the following material was received for the record:)

TREASURY DEPARTMENT,
Washington, D.C., August 16, 1966.

HON. PAUL H. DOUGLAS,
U.S. Senate, Washington, D.C.

DEAR SENATOR DOUGLAS: Pursuant to your request at the public hearings held August 9, 1966, on H.R. 13103, I enclose three copies each of tables which describe the estate tax and income tax treatment of bank deposits and the interest derived therefrom in nine major foreign countries.

If you or your staff have any further questions concerning the enclosed, I will be happy to try to answer them for you.

Sincerely yours,

STANLEY S. SURREY,
Assistant Secretary.

OFFICE OF THE SECRETARY OF THE TREASURY

Treatment of bank deposits held by nonresidents under the estate tax laws of selected countries

Taxing country:	*Treatment of deposits*
France	Exempt.
Germany	Do.[1]
Italy	Taxable.[2]
Netherlands	Not available.
Switzerland	Exempt.[3]
United Kingdom	Taxable.[4]
Canada	Do.[5]
Japan	Do.
Belgium	Exempt.[6]

[1] The exemption in Germany is conditioned upon the fact that the recipient is a nonresident of Germany.
[2] Apparently taxable, though available sources do not note this fact specifically.
[3] There are no Federal, estate, or succession taxes imposed by Switzerland. Although cantonal estate tax duties are imposed, bank deposits are not subject to such cantonal estate taxes.
[4] Our information indicates that as a practical matter, while bank deposits are technically subject to U.K. estate tax, no tax actually is imposed.
[5] A 15 percent Canadian estate tax is imposed on that portion of bank deposits of foreigners which exceed $5,000.
[6] The exemption in Belgium is conditioned upon the fact that the decedent was not domiciled in, and did not have his "siege de sa fortune" in Belgium.

Treatment of interest on bank deposits held by nonresidents under income tax laws of selected countries

Source country:	*Withholding rate*
France	25 percent.[1]
Germany	Exempt.
Italy	27 percent plus local surcharges.[2]
Netherlands	Exempt.
Switzerland	27½ percent.[3]
United Kingdom	41¼ percent.[4]
Canada	15 percent.[5]
Japan	20 percent.[6]
Belgium	Exempt.[7]

[1] As of Jan. 1, 1965, France imposes a 25-percent withholding tax on interest derived by foreigners from deposits with French banks. However, no such tax is imposed if the deposit is made in a "foreign currency," e.g., U.S. dollars.
[2] The total rate varies, but averages about 32.4 percent.
[3] The 27½-percent withholding rate will be raised to 30 percent beginning Jan. 1, 1967. However, because Swiss banks frequently do not pay interest on deposits (indeed there is often a charge for depositing money in a so-called "numbered account") the rate of Swiss withholding tax is of no practical importance.
[4] Although interest derived by foreigners from bank deposits in U.K. banks technically is subject to U.K. standard tax of 41¼ percent, there is no withholding of such tax on "short interest," i.e., interest derived from deposits of less than 1 year's duration (U.K. authorities state that the overwhelming majority of deposits in U.K. banks by foreigners generate "short interest").
[5] When the deposit has been made in a foreign currency and the interest is payable in a foreign currency no tax is withheld.
[6] This rate is temporarily reduced to 10 percent in some cases, but will apparently revert back to 20 percent in 1967.
[7] Pursuant to a law enacted in 1962, a withholding tax applicable to foreigners deriving interest from bank deposits in Belgium was to become effective Jan. 1, 1965. However, the effective date of such tax was postponed first to Jan. 1, 1966, and subsequently to Jan. 1, 1967.

Senator DOUGLAS. Does your bank have that information, Mr. Barth?

Mr. BARTH. We will try to put it together. We have been working on it for some time, but unfortunately, we have not got the complete information, but we will get it.

Senator DOUGLAS. Would you submit such material as you have and then we can make a comparison between the two.

Mr. BARTH. Yes, sir.

Senator DOUGLAS. Thank you very much.

(The information referred to follows:)

THE CHASE MANHATTAN BANK,
New York, N.Y., August 11, 1966.

Hon. PAUL H. DOUGLAS,
U.S. Senate,
Washington, D.C.

DEAR SIR: Please permit me to express appreciation for the opportunity to appear before the Committee on Finance of the U.S. Senate on August 9, 1966, in connection with H.R. 13103. I am most grateful for the kind attention you and the other members of the committee afforded to me at the hearing.

As agreed, I transmit for your information and that of the committee a schedule prepared by bank counsel which sets forth our understanding of the foreign income taxation of interest on bank deposits and the death taxation of bank deposits themselves held by nonresident aliens and foreign corporations not doing business in certain countries. The information contained in the schedule is the best that we have been able to obtain. The schedule does not cover the low countries (Holland and Belgium), but we are compiling that data and will forward it to you.

I should mention that as to the income taxation of such bank deposit interest in the United Kingdom, it is our understanding that while the British tax law does by its terms apply a 41.25-percent rate, there is no withholding thereon. Further, the United Kingdom takes the position that they do not have tax jurisdiction to assess the tax against a nonresident. Thus, there is a technical liability but under the British concept of taxing jurisdiction, as we understand it, collection of the tax is not undertaken where there is no withholding.

I trust that the enclosure will prove useful to you and to the other members of the committee. I am taking the liberty of transmitting herewith 25 copies of the enclosure. Naturally, if I can be of any assistance in connection with this matter, I will be most delighted to do so.

Very truly yours,

ALFRED W. BARTH, *Executive Vice President.*

Taxation by leading financial nations of bank deposits of nonresident aliens and foreign corporations not doing business there

PART I—TAXATION OF INTEREST ON BANK DEPOSITS OF NONRESIDENT ALIENS AND FOREIGN CORPORATIONS NOT DOING BUSINESS IN THE SUBJECT COUNTRY [1]

Country	Tax applicable	Rates	Withholding
France	No (if deposit in dollars or other foreign currency).		
Germany	No		
Italy	Yes (practice of Italian banks to bear tax, as permitted by law).	27 percent (plus local collection charges up to 5 percent).	Yes.
Japan	Yes	20 percent	Do.
Spain	do	24 percent [2]	Do.[3]
Switzerland	do	27 percent (plus 3 percent coupon tax); 30 percent (overall) effective Jan. 1, 1967.	Yes (unless redeposited by Swiss bank on a fiduciary basis).
United Kingdom	Yes (generally, however, the nonresident cannot be assessed).	41.25 percent	No.
Canada [4]	No (if deposit in dollars or other foreign currency).		

See footnotes at end of table.

PART II—DEATH TAXES IN RESPECT OF BANK DEPOSITS OF NONRESIDENT ALIENS NOT DOING BUSINESS IN THE SUBJECT COUNTRY[1]

Country	Tax applicable	Rates
France	Yes[2]	Graduated (tax will vary depending on relationship of beneficiaries to decedent).
Germany	No (unless resident beneficiaries)	
Italy	Yes	Do.
Japan	do	Do.
Spain	do	Do.
Switzerland	No	
United Kingdom	No (unless operation of account directed or withdrawals made in United Kingdom, or unless nonresident depositor physically made deposits or withdrawals in United Kingdom.	Graduated.
Canada[2]	Yes	15 percent.

[1] General source: Information obtained through CMB (through foreign branches and representative offices).
[2] Source: General reference works and/or interpretation of statutes and treaties.

THE CHASE MANHATTAN BANK,
New York, N.Y., August 19, 1966.

HON. PAUL H. DOUGLAS,
U.S. Senate,
Washington, D.C.

DEAR SENATOR DOUGLAS: The schedule forwarded to you by my letter of August 11, 1966, did not cover the tax treatment of bank deposits in the Netherlands and Belgium since we did not at that time have the necessary information.

We have now been informed that no income tax and no withholding are imposed on bank deposit interest in the Netherlands and Belgium earned by nonresident aliens and foreign corporations not doing business in those two countries. Likewise, no death taxes are imposed on such deposits.

Again permit me to express my sincere appreciation for your kind attention and that of the committee at the hearing on August 9, 1966, in connection with H.R. 13103.

Sincerely yours,

ALFRED W. BARTH, *Executive Vice President.*

Senator WILLIAMS. Mr. Barth, you have been most cooperative this morning and I hesitate to delay you further, but could you tell us generally what residence is claimed by these so-called roving depositors?

Mr. BARTH. I could not hear you, Senator.

Senator WILLIAMS. I say, generally speaking——

Mr. BARTH. Yes.

Senator WILLIAMS. What residence is taken or claimed by these so-called roving depositors or are they just referred to generally as being scattered around among various countries?

Mr. BARTH. By far the majority of these deposits are in Western Europe, and I believe that the largest holdings are in London, England. I am speaking of dollar deposits, not sterling; London, England, has become the center of the external or Euro-dollar operations because, as I have explained to you, even during the war the Bank of England never interfered with any foreign exchange operation that involved a non-Britisher, and London has been the financial headquarters of the world for a long, long time; and, as you will notice from these gross deposits, the majority is kept in London because people still have faith in the British banks.

Senator WILLIAMS. And they are mostly British citizens then?

Mr. BARTH. British banks.

Senator WILLIAMS. The citizenship of the depositor is what I was interested in.

Mr. BARTH. The citizenship of the depositor, Middle East, Swiss, French, Italian, South American, Canadian, Scandanavian, all over the world.

Senator WILLIAMS. Thank you.

The CHAIRMAN. You are going to furnish us with a thought or two that you had on this subject in writing, and I would appreciate it if you would do that.

Mr. BARTH. Yes, sir; gladly.

The CHAIRMAN. At your convenience we would like to see it.

Thank you very much, Mr. Barth. We appreciate your testimony here today.

Mr. BARTH. Thank you very much, Mr. Chairman, and members of the committee.

The CHAIRMAN. The next witness is Mr. William F. Ray of the Bankers' Association for Foreign Trade, who is accompanied by his counsel, Mr. Thomas Baer. Mr. Ray and Mr. Baer, we are happy to have you here.

STATEMENT OF WILLIAM F. RAY, PRESIDENT, BANKERS' ASSOCIATION FOR FOREIGN TRADE, ACCOMPANIED BY THOMAS BAER, COUNSEL

Mr. RAY. Thank you, Senator Long. My name is William F. Ray. I am president of the Bankers' Association for Foreign Trade, and I want to express our appreciation for the opportunity to come here and be heard.

May I say, Senator Carlson, that I can sympathize with your airline difficulties. I had to make that trip in reverse last night, and I did not think I would make it.

The Bankers' Association for Foreign Trade includes among its membership 128 American banks. We were founded in 1921 by a small group of bankers from Buffalo, Cleveland, and Detroit, and our organization has now grown to include nearly every bank in the United States which has a fully organized foreign department.

At our annual meeting which took place on April 27, our organization unanimously adopted a resolution which opposed certain sections of H.R. 13103 as passed by the House. The text of the resolution is a supplement to our statement.

While we generally endorse the objectives of H.R. 13103, our membership is concerned about the sections of the bill which impose an income and estate tax on foreign-owned bank deposits in the United States.

We point out in our statement that the exemption of such deposits from such taxation goes back to the Revenue Act of 1921, and when that act was being considered, the Congress recognized that the loss of revenue which would result if this deduction were allowed would be relatively small in amount, while the exemption of such interest from taxation would be in keeping with the action of other countries and would encourage nonresident alien individuals and foreign corporations to transact financial business through institutions located in the United States. And, in our opinion, the reasons which were persuasive to the Congress in 1921 are equally valid today.

It is our understanding that many leading foreign countries, including England, Germany, the Netherlands, and Sweden also do not impose a withholding tax on interest paid on deposits of nonresident aliens, so that our domestic banks would be placed at a disadvantage with respect to competition on this point from these important financing countries.

May I take a little time to point out the experience of Germany, which, when it was concerned over an excessive inflow of capital, took a step that was somewhat analogous to placing a tax on the interest on money deposited in banks. The German Government proposed and later enacted a tax on bond coupons paid to foreigners. This experience is described in the monthly bulletin of the German Central Bank for June 1965.

It may be summarized as follows:

The mere publication of the proposed German coupon tax in March 1964, in accordance with which interest paid on German bonds owned by foreigners was to be subject to a withholding tax, reduced foreign purchases of such bonds to about 50 percent of the amount that had been purchased by foreigners in each of the preceding months of that year. The parliamentary approval of the tax bill in January of 1965 and February of 1965 again resulted in an excess of sales over purchases. All in all, 550 million deutschemarks of foreign funds were withdrawn from Germany through the excess of sales over purchases of foreign-owned German bonds in the 14-month period beginning with the publication of the proposed tax, and ending in April 1965.

This spectacular figure must be compared with that of the net purchases by foreigners in the 14-month period immediately preceding the publication of the proposed tax act. In this period the purchases of German bonds by foreigners totaled 2.36 billion deutschemarks.

The German Central Bank article further points out that following the enactment of the coupon tax, there was a rise of more than 1 percent per annum in the interest rate level prevailing in Germany. The coupon tax is cited by the Central Bank as one of the contributing causes. Do we need this kind of upward pressure on interest rates in this country?

We point out that the proposed tax on interest affects a larger deposit total than the proposed estate tax, for it includes time deposits of banks, corporations and others, as well as individuals and apparently it was recognized that a potentially undesirable effect existed when the bill was drafted to defer the application of this withholding tax until January 1972.

However, in our opinion, substantiated by the German experience with the interest withholding tax cited above, the mere existence of the provisions in the law will itself result in withdrawal of deposits, as I believe was mentioned by Mr. Barth.

Our member banks have advised us that this process has already begun following passage of H.R. 13103 by the House. It is clear that the anticipation of action, even as distant as that presently proposed by 1972, can become an active force in the sensitive international money market.

On the matter of estate tax, the provisions would become immediately effective. Our member banks have advised us again that some deposits have already been withdrawn, and that steps have been taken to move additional deposits. This experience seems to illustrate the fact that the proposed estate tax is contrary to one of the purposes of H.R. 13103, to encourage the investment of foreign funds in the United States.

The facts are that it is too easy to move such funds to dollar accounts in foreign banks outside the control of the United States, or to have the deposit made through a closely held foreign corporation and, therefore, the estate tax revenues from this source to our Government would be miniscule—the Treasury estimate, I believe, is $300,000 per year—and not worth the risk of potential loss of dollar deposits.

The tax changes affecting bank deposits of foreigners as proposed in H.R. 13103 could be particularly damaging to 115 of our American members that have no branches abroad, which might be able to acquire some of the deposits shifted from this country.

The loss of these deposits would do serious damage to such banks. Large banks with foreign branches may be able to attract some of these departing deposits back into these branches, and the depositor would then be free of tax. Some of us without foreign branches may have to consider opening such branches in order to avoid the extinction of our foreign business. Others simply cannot do that and the loss of these deposits would do serious damage to these banks.

Business related to these deposits would presumably also be lost when the deposits were transfererd to other banks or branches abroad or simply repatriated. Many of these smaller banks have spearheaded in their communities the U.S. Government's export promotion drive, in many cases through newly established or revitalized international banking divisions built around export financing. Their abilty to make these efforts self-supporting has necessarily been reduced by the present tightness of money and by the foreign lending guidelines of the Federal Reserve System, which include loans to finance exports.

The tax provisions of H.R. 13103 affecting time deposits will hamper the ability of some of these banks to develop their facilities for export financing by reducing the earnings and the deposit base of their international banking divisions.

We believe that the shift in deposits which will take place if H.R. 13103 is enacted in its present form will seriously diminish the functions of the U.S. banking system as a depository of dollar holdings of foreigners. We recognize that some of the deposits now on the books of American banks in the name of nonresident foreign individuals will simply be shifted to the accounts of foreign banks, and thus remain deposited in the United States. However, the effect of moving these deposits to dollar accounts of banks outside the control of the United States is to intensify the danger to our monetary reserves. The foreign bank would not have the same obligation that an American bank would feel for taking part in any program of the United States for voluntary cooperation and restraint, and the foreign bank, moreover, is not subject to our laws and regulations.

Consequently, the foreign bank will seek the best return available on its funds consistent with safety and liquidity wherever that may be, and it will have no hesitation in selling the dollars it holds for other foreign currencies. Dollars thus sold are likely to wind up in the hands of foreign central banks, where they constitute a direct claim on our gold supply.

Under currently prevailing practice a substantial portion of the net new reserves acquired by foreign central banks is converted into gold. The concern both here and abroad about the continuing drain on our gold reserves needs no comment.

Moreover, some foreign holders of dollars would not be prepared to hold these dollars on deposit with a bank outside the United States for various reasons, including transfer risks political risks, and credit risks.

Faced with a tax liability, such owners of dollars may decide to repatriate them. That means to convert them into their own domestic currency by selling them. The ultimate purchaser of these dollars is often a foreign central bank, so that the end effect of this transaction is again a potential drain on our gold supply.

We believe that these provisions of H.R. 13103 proposing to tax bank deposits do not recognize that the dollar is a major international reserve currency; that a major portion of international trade is done in dollars and that, as a result, the United States has become the financial center of the world.

Since this is the case, and because foreign deposits have always provided an important part of the financing of our own foreign trade, any action to force foreign holdings of dollar deposits to accounts at foreign banks is clearly contrary to our national interests. There can be no doubt that the provisions with regard to bank deposits in H.R. 13103 adversely affect the status of foreign dollar holdings.

In summary, we believe that the present exemptions from income and estate tax on bank deposits granted to nonresident aliens should be continued for (1) the taxes proposed by H.R. 13103 on such deposits will create a less favorable climate for foreign investment in the United States; (2) they will drive foreign deposits out of the United States and thus yield only negligible tax revenue; (3) they will lead to a potential further drain on the U.S. gold stock of menacing proportions; and (4) they are particularly damaging to the normal business operations of those U.S. banks, including many smaller banks which have no foreign branches.

Thank you, Mr. Chairman.

(The prepared statement of Mr. Ray follows:)

STATEMENT OF WILLIAM F. RAY, ON BEHALF OF THE BANKERS' ASSOCIATION FOR FOREIGN TRADE, ON H.R. 13103

TABLE OF CONTENTS AND SUMMARY SHEET

We believe that the exemptions from income and estate tax on bank deposits granted to nonresident aliens in the Revenue Act of 1921 should be continued for (1) the taxes proposed by H.R. 13103 on such deposits will create a less favorable climate for foreign investment in the United States; (2) will drive foreign deposits out of the United States and thus yield only negligible tax revenue; (3) will lead to a potential further drain on the United States gold stock of menacing proportions, and (4) are particularly damaging to the normal business operations of those United States banks, including many smaller banks, which have no foreign branches.

WHO BAFT REPRESENTS

The Bankers' Association for Foreign Trade includes among its membership 128 American banks from all parts of the United States as shown on the attached list (Appendix A). Our organization was founded in 1921 by a small group of bankers from Buffalo, Cleveland and Detroit, and now has grown to include nearly every bank in the United States having a fully organized foreign or international department.

The purposes of the BAFT, as stated in its by-laws, are "to promote international banking and foreign trade by doing all things appropriate to the stimulation of public interest therein and to the improvement of existing practices and the development of new techniques thereof."

COOPERATION OF BAFT WITH GOVERNMENT AGENCIES

The BAFT has cooperated closely with the representatives of the various government departments and financing agencies concerned with international trade and financing. As examples of this cooperation, for some time the Export-Import Bank has appointed our President to serve on its Advisory Committee during his term of office and, more recently, our President has also been named to the National Export Expansion Council. Many of the officers of our member banks have served as chairmen or members of the various Regional Export Expansion Councils.

BAFT RESOLUTION AT ANNUAL MEETING RE H.R. 13103

At the annual meeting of our Association on April 27, a resolution was adopted unanimously opposing certain sections of H.R. 13103 as passed by the House of Repersentatives (see Supplement B). While generally endorsing the objectives of H.R. 13103, our membmership is concerned about the sections of this Bill which impose an income and estate tax on foreign owned bank deposits held in the United States. We believe (1) that these provisions are contrary to one of the stated objectives of H.R. 13103, namely, to attract foreign investment in the United States, (2) that they will affect unfavorably the ability of American banks to do a foreign business and, (3) they will not accomplish the revenue purposes for which they were designed; business will merely be shifted from American banks to their foreign competitors and the payment of an important part of the proposed taxes will be avoided.

We, therefore, urge that H.R. 13103 be amended by dropping the privisions that would tax foreign owned bank deposits so that the law would continue as at present, namely:

(a) that interest on such deposits would continue to remain exempt from Federal income tax and withholding;

(b) that such deposits would continue to remain exempt from Federal estate taxation.

FORTY-FIVE YEAR HISTORY OF TAX EXEMPTIONS FOR FOREIGN-OWNED BANK DEPOSITS

To fail to accord such exemptions would be to reverse a long-standing policy of the United States established in the Revenue Act of 1921. In considering the merits of this exclusion from taxable income over 40 years ago, the House Ways and Means Committee recognized that the loss of revenue which would result if this deduction were allowed would be relatively small in amount, while the exemption of such interest from taxation would be in keeping with the action of other countries and would encourage non-resident alien individuals and foreign corporations to transact financial business through institutions located in the United States. In our opinion, the reasons which were persuasive to the Congress in 1921 are equally valid today.

PRACTICE OF OTHER COUNTRIES

Furthermore, it is our understanding that many leading foreign countries including England, Germany and the Netherlands, do not impose a withholding tax on interest paid on deposits of non-resident aliens so that our domestic banks would be placed at a disadvantage with respect to competition on this point in these important financing countries. It is instructive that Germany, when concerned over an excessive *in*flow of capital, took a step that was somewhat analogous to a tax on depositing money in banks. The German government proposed, and later enacted, a tax on bond coupons paid to foreigners. This experience is described in the monthly bulletin of the German Central Bank for June, 1965, and may be summarized as follows:

> The mere publication of the proposed German Coupon Tax in March, 1964 (according to which interest paid on German bonds owned by foreigners was to be subject to a withholding tax) reduced foreign purchases of such bonds to about 50% of the amount that had been purchased by foreigners in each of the preceding months. The parliamentary approval of the tax bill on January 27, 1965, and February 12, 1965, again resulted in an excess of sales over purchases. All in all, 550 million DM of foreign funds were withdrawn from Germany through the excess of sales over purchases of foreign-owned German bonds in the fourteen-month period beginning with the publication of the proposed tax act and ending in April 1965. This spectacular figure must be compared with that of the net purchases by foreigners in the fourteen-month period immediately preceding the publication of the proposed tax act. In this period, the purchases of German bonds by foreigners totalled 2.36 billion DM.

The German Central Bank article further points out that, following the enactment of the Coupon Tax, there was a rise of more than 1% per annum in the interest rate level prevailing in Germany; the Coupon Tax is cited by the Central Bank as one of the contributing causes. Do we need this kind of added upward pressure on interest rates in this country?

PROPOSED INCOME AND WITHHOLDING TAX ON INTEREST ON FOREIGN-OWNED BANK DEPOSITS

The proposed tax on interest affects a larger deposit total than the proposed estate tax, for it includes time deposits of banks, corporations, trusts and other entities as well as those of individuals. Apparently the draftsmen of H.R. 13103 recognized a potential undesirable effect of this proposed tax which they sought to mitigate by deferring the application of this withholding tax until January 1, 1972. However, in our opinion, substantiated by the German experience with the bond interest withholding tax cited above, the mere existence of the provisions in the law will itself result in withdrawal of deposits. Our member banks have advised us that this process has already begun following passage of H.R. 13103 by the House. It is clear that the anticipation of action, even as distant as that presently proposed for 1972, can become an active force in the sensitive international market.

PROPOSED ESTATE TAX ON FOREIGN-OWNED BANK DEPOSITS

Under the proposed law, the estate tax provisions would become immediately effective. Our member banks advise us that some individual deposits have already been withdrawn and that steps have been taken to move additional deposits. This experience seems to illustrate the fact that the proposed estate tax on bank deposits is contrary to the purpose of H.R. 13103 to encourage the investment of foreign funds in the United States. The facts are that it is too easy to move such funds to dollar accounts in foreign banks outside the control of the United States or to have the deposit made through a closely held foreign corporation and, therefore, the estate tax revenues from this source to our government would be minusule (Treasury estimate $300,000 per year) and not worth the risk of potential loss of dollar deposits.

EFFECT OF INTEREST AND ESTATE TAX PROVISIONS OF HR 13103 ON SMALLER BANKS

The tax changes affecting bank deposits of foreigners as proposed in HR 13103 could be particularly damaging to approximately 115 of our American members that have no branches abroad which might be able to acquire some of the deposits shifted from this country. The loss of these deposits would do serious damage to such banks. Large banks with foreign branches may be able to attract some of these departing deposits back into their branches, and the depositor would then be free of tax. Some of us without foreign branches may have to consider opening such branches in order to avoid extinction of an important source of our foreign business. Others simply cannot do that and the loss of these deposits would do serious damage to such banks. Business related to these deposits would presumably also be lost when the deposits were transferred to other banks or branches abroad or simply repatriated. Many of these banks have spearheaded in their communities the U.S. Government's export promotion drive of recent years, in many cases through newly established or revitalized International Banking Divisions built around export financing. Their ability to make these efforts self-supporting has necessarily been reduced by the present tightness of money and the foreign lending guidelines of the Federal Reserve System (which include loans to finance exports). The tax provisions of HR 13103 affecting time deposits will hamper the ability of some of these banks to develop their facilities for export financing by reducing the earnings and the deposit base of their International Banking Divisions.

EFFECT ON DEPOSITS AND ON OUR GOLD SUPPLY

We believe that the shift in deposits which will take place if HR 13103 is enacted in its present form will seriously diminish the functions of the United States banking system as a depository of dollar holdings of foreigners. We recognize that some of the deposits now on the books of American banks in the name of nonresident foreign individuals will simply be shifted to the accounts of foreign banks and thus remain deposited in the United States. However, the effect of moving these deposits to dollar accounts of banks outside the control of the United States is to intensify the danger to our monetary reserves. The foreign bank would not have the same obligation that an American bank would feel for taking part in any program of the United States for voluntary cooperation and restraint and the foreign bank is moreover not subject to our laws and regulations. Consequently, the foreign bank will seek the best return available on its funds consistent with safety and liquidity wherever that may be and it will have no hesitation in selling dollars it holds for other foreign currencies. Dollars thus sold are likely to wind up in the hands of foreign central banks where they constitute a direct claim on our gold supply.

Under currently prevailing practice, a substantial portion of the net new reserves acquired by foreign central banks is converted into gold. The concern both here and abroad about the continuing drain on our gold reserves needs no comment.

Moreover, some foreign holders of dollars would not be prepared to hold these dollars on deposit with a bank outside the United States for various reasons, including transfer risks, political risks and credit risks. Faced with a tax liability, such owners of dollars may decide to repatriate them, that is, to convert them into their own domestic currency by selling them. The ultimate purchaser of these dollars is often a foreign central bank, so that the end effect of this transaction is again a potential drain on our gold supply.

In addition, these provisions of HR 13103 proposing to tax bank deposits do not seem to recognize that the dollar is a major international reserve currency, that a major portion of international trade is done in dollars, and that, as a result, the United States has become the financial center of the world. Since this is the case—and because foreign deposits have always provided an important part of the financing of our own foreign trade—any action to force foreign holdings of dollar deposits to accounts at foreign banks is clearly contrary to our national interest. There can be no doubt that the provisions with regard to bank deposits in HR 13103 do adversely affect the status of foreign dollar holdings.

SUMMARY OF CONCLUSIONS

In summary, we believe that the exemptions from income and estate tax on bank deposits granted to non-resident aliens in the Revenue Act of 1921 should be continued for (1) the taxes proposed by HR 13103 on such deposits will create a less favorable climate for foreign investment in the United States; (2) will drive foreign deposits out of the United States and thus yield only negligible tax revenue; (3) will lead to a potential further drain on the United States gold stock of menacing proportions, and, (4) are particularly damaging to the normal business operations of those United States banks, including many smaller banks, which have no foreign branches.

UNITED STATES MEMBERS, BANKERS' ASSOCIATION FOR FOREIGN TRADE, JULY 21, 1966

APPENDIX A

Akron, Ohio: First National Bank of Akron
Atlanta, Georgia:
The Citizens & Southern National Bank
First National Bank of Atlanta
The Trust Company of Georgia

UNITED STATES MEMBERS, BANKERS' ASSOCIATION FOR FOREIGN TRADE, JULY 21, 1966—Continued

APPENDIX A—continued

Baltimore, Maryland;
- First National Bank of Maryland
- Maryland National Bank
- Union Trust Company of Maryland

Boston, Massachusetts:
- First National Bank of Boston
- The National Shawmut Bank of Boston
- The New England Merchants National Bank of Boston
- State Street Bank & Trust Company

Buffalo, New York:
- Manufacturers and Traders Trust Company
- Marine Midland Trust Company of Western New York

Charlotte, North Carolina: North Carolina National Bank

Chicago, Illinois:
- American National Bank & Trust Co. of Chicago
- Central National Bank of Chicago
- Continental Illinois National Bank and Trust Company of Chicago
- First National Bank of Chicago
- Harris Trust and Savings Bank
- LaSalle National Bank
- Northern Trust Company

Cincinnati, Ohio:
- The Central Trust Company
- Fifth-Third Union Trust Company
- First National Bank of Cincinnati

Cleveland, Ohio:
- Central National Bank of Cleveland
- The Cleveland Trust Company
- The National City Bank of Cleveland
- Society National Bank of Cleveland
- Union Commerce Bank

Dallas, Texas:
- First National Bank of Dallas
- Mercantile National Bank at Dallas
- Republic National Bank of Dallas

Denver, Colorado: Denver United States National Bank

Detroit, Michigan:
- Bank of the Commonwealth
- City National Bank of Detroit
- Detroit Bank & Trust
- Manufacturers National Bank of Detroit
- National Bank of Detroit

Forth Worth, Texas:
- First National Bank of Fort Worth
- Forth Worth National Bank

Hartford, Connecticut:
- Connecticut Bank and Trust Company
- Hartford National Bank & Trust Company

Honolulu, Hawaii:
- Bank of Hawaii
- The First National Bank of Hawaii

Houston, Texas:
- Bank of the Southwest National Association
- The First City National Bank of Houston
- Texas National Bank of Commerce of Houston

Indianapolis, Indiana:
- American Fletcher National Bank & Trust Co.
- The Indiana National Bank of Indianapolis

Kansas City, Missouri:
- City National Bank & Trust Company
- Commerce Trust Company
- First National Bank

UNITED STATES MEMBERS, BANKERS' ASSOCIATION FOR FOREIGN TRADE, JULY 21, 1966—Continued

APPENDIX A—continued

Los Angeles, California:
- First Western Bank and Trust Company
- Manufacturers Bank
- Security First National Bank
- Union Bank
- United California Bank

Memphis, Tennessee:
- First National Bank of Memphis
- National Bank of Commerce in Memphis
- Union Planters National Bank

Miami, Florida: The First National Bank of Miami

Milwaukee, Wisconsin:
- First Wisconsin National Bank of Milwaukee
- Marshall & Ilsley Bank

Minneapolis, Minnesota:
- First National Bank of Minneapolis
- Northwestern National Bank of Minneapolis

Mobile, Alabama:
- First National Bank of Mobile
- Merchants National Bank of Mobile

Newark, New Jersey: National Newark & Essex Banking Company

New Orleans, Louisiana:
- Hibernia National Bank in New Orleans
- National American Bank of New Orleans
- The National Bank of Commerce in New Orleans
- Whitney National Bank of New Orleans

New York, New York:
- American Express Company
- The Bank of New York
- Bankers Trust Company
- Brown Brothers Harriman & Co.
- The Chase Manhattan Bank
- Chemical Bank New York Trust Company
- Empire Trust Company
- The First National City Bank
- Franklin National Bank
- Irving Trust Company
- Laidlaw & Company
- Manufacturers Hanover Trust Company
- Marine Midland Grace Trust Company of New York
- The Meadow Brook National Bank
- Morgan Guaranty Trust Company of New York
- Sterling National Bank and Trust Company

Norfolk, Virginia: Virginia National Bank

Oakland, California: Central Valley National Bank

Omaha, Nebraska: The Omaha National Bank

Paterson, New Jersey: New Jersey Bank and Trust Company

Philadelphia, Pennsylvania:
- Central-Penn National Bank of Philadelphia
- Fidelity-Philadelphia Trust Company
- First Pennsylvania Banking & Trust Company
- Girard Trust Bank
- The Philadelphia National Bank
- Provident National Bank

Phoenix, Arizona:
- First National Bank of Arizona
- Valley National Bank

Pittsburgh, Pennsylvania:
- Mellon National Bank & Trust Company
- Pittsburgh National Bank

Ponce, Puerto Rico:
- Baco Credito y Ahorro Ponceno
- Banco de Ponce

UNITED STATES MEMBERS, BANKERS' ASSOCIATION FOR FOREIGN TRADE, JULY 21, 1966—Continued

APPENDIX A—continued

Portland, Oregon: The First National Bank of Oregon
Providence, Rhode Island:
- Industrial National Bank of Rhode Island
- Rhode Island Hospital Trust Company

St. Louis, Missouri:
- First National Bank in St. Louis
- Mercantile Trust Company

San Diego, California: First National Bank of San Diego
San Francisco, California:
- Bank of America, N.T. & S.A.
- Bank of California, N.A.
- Crocker-Citizens National Bank
- Pacific National Bank of San Francisco
- Wells Fargo Bank

San Juan, Puerto Rico: Banco Popular de Puerto Rico
Seattle, Washington:
- The National Bank of Commerce of Seattle
- Pacific National Bank of Seattle
- Peoples National Bank of Washington
- Seattle-First National Bank

Tacoma, Washington: National Bank of Washington
Tampa, Florida: Marine Bank & Trust Company
Toledo, Ohio: First National Bank of Toledo
Tucson, Arizona: Southern Arizona Bank and Trust Company
Washington, D.C.:
- American Security and Trust Company
- The Riggs National Bank of Washington, D.C.

Winston-Salem, North Carolina: Wachovia Bank & Trust Company
Worcester, Massachusetts: Worcester County National Bank

SUPPLEMENT B—RESOLUTION ADOPTED BY THE BANKERS' ASSOCIATION FOR FOREIGN TRADE AT THEIR ANNUAL MEETING—APRIL 27, 1966

We support the general objectives of H.R. 13103, the "Foreign Investors Tax Act of 1966", and the section which classifies as foreign source income interest paid on accounts of all types of depositors in foreign branches of United States banks. We do, however, strongly oppose the provisions of the bill which would impose income and inheritance taxes on certain foreign owned deposits in the United States and on certain debt obligations located outside the United States and owned by non-residents. We are convinced that these provisions will have a detrimental effect on the United States balance of payments and on the position of the United States as a financial center of the world, and that they are in direct conflict with the stated objectives of H.R. 13103.

The CHAIRMAN. Have you had the opportunity to present these arguments of the Bankers' Association for Foreign Trade against this provision of the House bill prior to the time that the House provision was agreed to?

Mr. RAY. We did not have that opportunity. Were hearings held at that time, Senator Long?

The CHAIRMAN. Well, I would assume that if you did not have the opportunity to testify, the House simply met on H.R. 13103 after the hearings had been concluded and the amendment was offered in executive session without your having had a chance to present your arguments.

Mr. RAY. This is the first presentation that we have made of these arguments.

The CHAIRMAN. I am informed that there was opportunity to be heard on it, but that it was on very short notice and there was little time between the announcement of hearings on the subject and the time when the House had an executive session on it.

Thank you very much. I will see that your statement and your arguments are further considered by the committee.

Mr. RAY. Senator Long, may I add one further item.

I understand that the Treasury is proposing an amendment which would exempt discount on bankers' acceptances of a maturity of 6 months or less from the imposition of withholding or income taxes. We are very pleased that they have introduced this suggestion. We believe it recognizes the importance of bankers' acceptances which are a very old but not very well understood means of supplying funds to the banking system for the financing for foreign trade.

Currently I believe there are outstanding $832 million of banker's acceptances which were created to finance exports.

The CHAIRMAN. Yes. I understand that the Treasury proposes that we have clarifying language in our committee report.

Well, thank you very much, sir. We will see that your arguments here are considered. I think you made a very fine argument.

Mr. RAY. Thank you, Senator.

The CHAIRMAN. We have a statement of Mr. L. D. Brace, chairman of the First National Bank of Boston, who decided to file his statement in lieu of a personal appearance and because his position was being stated by Mr. Ray.

(The statement referred to follows:)

THE FIRST NATIONAL BANK OF BOSTON,
Boston, Mass., August 3, 1966.

HON. RUSSELL B. LONG,
Chairman of the Senate Finance Committee,
New Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: In our letter of June 30, 1966, we requested the privilege of testifying before your committee during the hearings on the "Foreign Investors Tax Act of 1966" (H.R. 13103). Since then we have agreed with other United States banks affected by this bill to have Mr. William Ray, President of the Bankers Association for Foreign Trade, represent our joint interests before your committee. Therefore, we shall not have anyone appear at the hearings on our behalf. However, we take this opportunity to submit in writing our views concerning this bill.

We are opposed to the provisions of H.R. 13103 which:

1. Subject interest paid on U.S. bank deposits of nonresident aliens and foreign corporations to a U.S. withholding tax commencing January 1, 1972.
2. Subject bank deposits of nonresident aliens to U.S. estate taxes; and
3. Employ the "effectively connected" concept as a means to subject certain foreign source income to U.S. taxation.

As a result of our inquiries, we received letters from prominent European bankers indicating the serious effect H.R. 13103 will have on the U.S. balance of payments problem. These letters are enclosed with the request that they, together with this statement, be included in the printed record of the hearings.

A discussion of each of the provisions of H.R. 13103 to which we object follows:

1. H.R. 13103 would subject interest on bank deposits paid to nonresident aliens and foreign corporations to United States withholding tax beginning January 1, 1972.

Under present law foreigners are exempt from U.S. income and estate tax on their U.S. deposits if they are not engaged in trade or business within the United States. Accordingly, if enacted this bill, entailing withholding of interest at the rate of 30 percent would diminish the net earnings on foreign-owned deposits to about one-half of what the same investor could obtain in the European Eurodollar market. In view of this great disparity of interest rates, which is largely due to the fact that many of the developed European countries, such as England, Germany, France, Holland and Sweden, do not impose a similar tax, it seems certain that the enactment of this provision would not only discourage prospective foreign investors from depositing their money with United States banks, but would drive present foreign deposits out of this country and into the hands of foreign banks. Such a development would be neither in the interest of the American banking industry nor of the national economy as a whole as this would result in an outflow of dollars, which would constitute a potential further drain on the gold reserves of the United States.

It has been alleged that withdrawn deposits would return to the United States in some other form. Such an allegation is pure speculation. A foreign investor, who elected to invest his funds in the form of tax exempt U.S. bank deposits and at the same time to receive the benefits of a politically and economically stable country, might well decide to forego these latter advantages for a higher return by depositing his funds in another country where they would be tax exempt.

That the United States would sustain a dollar drain is indicated in the opinions of Mr. Gustav Glueck, the managing director of the Dresdner Bank AG and that of the Commerzbank, two leading German publicly owned banks. (Appendixes A and B.) In his letter of July 27, 1966, Mr. Glueck states that the provisions of H.R. 13103 affecting foreign owned bank deposits would substantially reduce the willingness of foreigners to deposit funds with American banks. He then draws an analogy to the German withholding tax imposed in 1964 on interest paid on German bonds held by nonresident aliens. He points out that such withholding tax not only stopped the further influx of foreign capital into Germany but also was a decisive factor in the deterioration of the German capital market. Support for Mr. Glueck's statement is found in the June, 1965, issue of "Monatsberichte der Deutschen Bundesbank" ("Monthly Bulletins of the German Centralbank"), Appendix C,* indicating that sales of German bonds by foreign investors exceeded purchases by 550 million DM in the fourteen months' period starting with the publication of the proposed law in March, 1964, and ending in April, 1965. This figure is all the more significant when compared with the 2.36 billion DM of German bonds which foreigners had purchased in the fourteen months' period preceding the publication of this proposed withholding tax law. The graph attached to Appendix C clearly reflects this trend, the red "balance" curve showing a varying excess of sales over purchases of German bonds by foreigners in the period of March, 1964, through May, 1965.

Particularly important in today's economy is the fact that a substantial withdrawal of foreign owned bank deposits would further restrict the already tight money supply of U.S. banks. This, in turn, would increase the pressure for loans from the Federal Savings and Loan institutions and other lending agencies. The net result, of course, would be further pressure to increase domestic interest rates. This, in itself, would be contrary to the present policies of the Federal Reserve Bank, embodied in the latest supplement of the Federal Reserve Bank of Boston to Regulation Q, Par. 217.6 of July 20, 1966. By way of comparison, it may be noted that the interest rate of German bonds rose by more than one percent following the enactment of the German withholding tax (cf. chart 2 of appendix C).

The adverse practical effects of subjecting bank deposits of foreigners to withholding tax appear clearly to outweigh and abstract equitable considerations of treating nonresident aliens on a tax parity with residents and citizens of the United States. This is especially true when such equitable considerations could well be repudiated on the ground that nonresident aliens do not receive the same benefits from the United States as do residents and citizens.

In addition, the proposed withholding tax would not affect all nonresident aliens uniformly since United States tax treaties with developed countries, such as Germany and the United Kingdom, frequently specifically exempt such interest payments from income taxation. In view of this discrimination, it is all the more difficult to accept the purely formalistic argument in support of this provision which seeks to justify this change because "interest income of this type is so clearly derived from United States sources." (See Ways and Means Committee Report, P. 7)

2. H.R. 13103 would subject bank deposits owned by nonresident aliens to the Federal Estate tax effective immediately upon enactment of this bill.

*Appendix C, referred to, may be found in the official files of the Committee.

Virtually the same objections, set forth above, to the proposed imposition of a withholding tax on interest apply to the proposed estate tax on U.S. bank deposits of nonresident alien individuals.

The obvious reason for the withholding on interest provision not to become effective until January 1, 1972, was the belief that the immediate enactment of the income tax provision would do serious harm to the United States balance of payments. The proposed estate tax by contrast would take effect immediately presumably because of the assumption that such a tax would not cause an outflow of dollars from the United States. This reasoning may well prove to be fallacious as it seems unlikely that an individual nonresident alien who, having the intention of withdrawing his deposits after 1971, would leave his money with a United States bank during the next five years and thus run the additional risk of falling within the ambit of the estate tax provision.

3. H.R. 13103 employs the "effectively connected" concept as a means of subjecting certain foreign source income to U.S. taxation.

H.R. 13103 introduces the novel concept of "effectively connected" (a) to distinguish between business and investment income and (b) to determine the amount of business income that should be subject to progressive United States income tax rates. According to the Report of the Ways and Means Committee, at page 14, the latter function of this concept was intended to curb the abuse of the existing U.S. source rules by foreign taxpayers engaged in trade or business within the United States. According to the bill, specified types of foreign source income, namely, (a) rents and royalties, (b) dividends and interest derived from the active conduct of a banking business and (c) certain sales income, would be subject to United States taxation if such income were "effectively connected" with the taxpayer's United States trade or business and if such taxpayer maintained a fixed place of business within the United States.

This new concept is meant to supersede a very important segment of the traditional source rules and should be as easy to apply as the rules that it would replace. However, it is submitted that the "effectively connected" concept would be far more difficult to administer than existing rules because there are no general guidelines for the future application of this term. This uncertainty about the administrative and judicial interpretation of this concept would, if enacted, tend to discourage prospective foreign investment in the United States.

It might also lead to withdrawal of deposits because interest paid on foreign owned U.S. bank deposits, including interest paid by foreign branches of U.S. banks, might be deemed "effectively connected" with a foreign taxpayer's United States trade or business and thus be subject to United States income taxation prior to January 1, 1972. This possibility would in particular discourage foreign banks which maintain United States branches from depositing dollars with United States banks, including their foreign branches.

Finally, the "effectively connected" concept would require our bank, acting as a withholding agent, to determine whether or not the interest it pays on foreign-owned bank deposits is "effectively connected" with the United States business of the depositor. This requirement would not only impose an extremely heavy administrative burden on the clerical staff of our bank but also would necessitate it either to pass upon intricate legal questions exceeding its professional capabilities or to obtain legal opinions. Apart from these difficulties, it even seems doubtful whether we would be able to collect all the necessary factual data from our clients to reach a decision in a specific case. In view of the personal liability and severe penalties applicable to withholding agents, it would theerfore seem likely that United States banks would deem most of the interest paid on foreign-owned bank deposits as not "effectively connected" with the depositor's United States business and thus subject them to the United States withholding tax provided for by H.R. 13103. Such a course of action would, however, not only greatly increase the administrative workload of United States banks but at the same time also defeat the proper and reasonable application of the new "effectively connected" concept.

For these reasons, we submit that the "effectively connected" concept be eliminated from H.R. 13103 altogether, or at least be limited in its application to United States source income.

Based on these considerations, we respectfully request that your Committee eliminate the provisions of H.R. 13103 indicated above.

Sincerely yours,

L. D. BRACE, *Chairman.*

GALLUSANLAGE 7, *July 27, 1966.*

MR. J. WARREN OLMSTED,
Executive Vice President,
The First National Bank of Boston,
Boston, Mass.

DEAR MR. OLMSTEAD: On return from a business trip abroad I found upon my desk your letter of July 6th, 1966 pertaining to "The Foreign Investors Tax Act of 1966".

The proposed provisions (1) in the tax bill entitled "The Foreign Investors Tax Act of 1966" (H.R. 13103) would certainly not be favorably received by international bankers. The proposed 30 per cent withholding-tax to be levied on interest paid by United States banks on deposits of foreigners, I am afraid, would substantially reduce the willingness to deposit funds with American banks, of investors, such as banks, commercial enterprises and private individuals. Even though a double taxation treaty concluded with the depositor's home country may permit full reimbursement of the taxes withheld or at least a partial set off against domestic taxes, it seems to me that the necessary procedures of getting full or partial compensation for the withheld taxes would of necessity cause delays and losses of interest income to potential depositors.

In this context, I believe, the experiences gained subsequent to the enactment of the 25% withholding-tax on interest paid on German bonds held by non-residents, which became law on March 28th, 1965 and effective firstly on the July 1st, 1965 coupon, may be of interest. The main aim of this so-called "coupon-tax" was to discourage foreign money to flow at the same rapid pace as in the previous months into Germany, where the then prevailing interest level was considered internationally very attractive. While the law proved quite effective in stopping the influx of funds into Germany, it has shaken the confidence of foreign investors and thus became a contributing factor to the deterioration of the German capital market which has been noticeable in the last two years.

I would have no objection to your submitting the above opinion to the Senate Finance Committee.

Yours sincerely,

GUSTAV GLUECK.

DÜSSELDORF, *July 27, 1966.*

MR. J. WARREN OLMSTED,
Executive Vice President, The First National Bank of Boston, International Division, Boston, Mass.

DEAR MR. OLMSTED: Your letter to Mr. G. Fuchs, Deputy General Manager, of July 6, 1966, has been referred to us for answering.

We are rather surprised that the United States Congress should consider to subject interest on foreign deposits with US-banks to United States income tax and the deposits themselves to United States estate tax.

As you are aware, banks in this country are at the present time not permitted to pay interest on foreign held deposits with the exception of savings deposits (restricted to individuals) and L/C cover accounts. No tax whatsoever is levied on these deposits and interest thereon. But the interest regulations have had a similar effect as would have had a tax. They have naturally caused non-residents—bankers as well as non-bankers—to keep their credit balances in Germany at the minimum required for their current operations and invest funds beyond this level elsewhere.

One may compare the problem with the German coupon tax, i.e. the withholding tax on interest paid by German debtors to non-resident bond owners. If the bond owner declares his income properly at home, he would normally be permitted to deduct there the tax paid in Germany. In case of the existence of a double taxation convention the German Internal Revenue would upon his producing proof of proper tax declaration at home reimburse him for the tax withheld in Germany.

The explicit purpose of the coupon tax has been to discourage foreign investors to import into Germany certain black moneys which had added to our increasing and undesired balance of payments surplus. The result has been disappointment among all foreign investors who very heavily have withdrawn from bond investments in Germany.

To what extent this development has contributed to the great change in our balance of payments during the last two years is difficult to assess, but the tendency as such has been quite obvious. We ought to repeat that this was exactly what the German legislator wanted. What he did not want, of course, was the very undesired contribution which this withdrawal of foreign investors made to the present deplorable condition of our capital market.

It would seem quite clear that taxes of the before-mentioned kind cannot but discourage foreign investors who would look for more friendly havens. Large foreign funds invested with US-banks, particularly with those heavily engaged in world-wide transactions, would certainly disappear and foreign holdings would shrink to working balances, thus reducing the flexibility and scope of their international operations. It seems difficult to understand, therefore, why a country suffering from complex structural balance of payments problems should take action to increase the deficit rather than to attract foreign capital. Admittedly, there are always various aspects to a problem and, unfortunately, they are sometimes conflicting.

We hope to have been of assistance to you. You may use these comments as you deem appropriate, although we do not think that we have produced big news.

Very truly yours,

COMMERZBANK, AKTIENGESELLSCHAFT.

The CHAIRMAN. Mr. Anthony Nizetich will not be able to appear here today. He canceled his appearance and sent us a letter signed by John E. Korth, assistant secretary-treasurer, and we will see that the letter is printed.

(The letter referred to follows:)

STAR-KIST FOODS, INC.,
Terminal Island, Calif., August 11, 1966.

Re H.R. 13103.

COMMITTEE ON FINANCE,
U.S. Senate,
New Senate Office Building,
Washington, D.C.
(Attention of Mr. Tom Vail, chief counsel).

GENTLEMEN: We believe that H.R. 13103 is ambiguous with respect to the "effectively connected" concept as embodied in proposed sections 864(c)(4) and section 882. We believe that enactment of these provisions as they are presently written would add to the uncertainties of tax compliance which already exist because of the Revenue Act of 1962 and the delays in issuing regulations under section 482 of the Internal Revenue Code. We believe that the 1962 Revenue Act together with sections 367 and 482 of the Internal Revenue Code give the Internal Revenue Service ample authority to control the shifting of income and expenses outside of the United States. We believe that the entire area of taxation of foreign source income has been thoroughly reviewed and resolved by the recently enacted Revenue Act of 1962.

As businessmen and taxpayers we need clearly defined tax rules and regulations on which to rely in making business decisions. Otherwise, we cannot stay competitive either at home or abroad. The proposed sections of H.R. 13103 as above cited will, in our opinion, accomplish just the opposite. Aside from needless record keeping and accounting requirements, they will create confusion and litigation for many years to come. As always in situations such as this, it is the small businessman who will suffer most.

In the case of small taxpayers in particular, we believe this proposed legislation would create undue hardships for two reasons. First, the small taxpayer will usually be compelled to concede in favor of the Revenue Service's position with respect to the "effectively connected" concept because he will find it too expensive to litigate the issues. Secondly, under the proposed legislation the larger taxpayers will be able to avoid its application in some instances by establishing an office or other fixed place of business outside the United States for their foreign subsidiaries. This tends to disfavor the small taxpayer who cannot economically support a separate foreign-based office location in order simply to avoid the "effectively connected" concept.

We must through necessity search out all of the seas of the world for an adequate supply of raw fish in our business. This proposed legislation would hinder this search and penalize our industry only because of the nature of our operations. In our opinion, this proposed legislation would place the U.S. tuna fishing industry at a competitive disadvantage with other countries of the world. Therefore, we strongly recommend that the "effectively connected" concept of H.R. 13103 be deleted.

Very truly yours,

JOHN E. KORTH,
Assistant Secretary-Treasurer.

The CHAIRMAN. That concludes this morning's hearing. We will resume tomorrow morning at 10 o'clock.

(Whereupon, at 11:25 a.m., the committee recessed to reconvene at 10 a.m., Wednesday, Aug. 10, 1966.)

FOREIGN INVESTORS TAX ACT OF 1966

WEDNESDAY, AUGUST 10, 1966

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

The committee met, pursuant to recess, at 10 a.m., in room 2221, New Senate Office Building, Senator Clinton P. Anderson presiding.

Present: Senators Long (chairman), Anderson, McCarthy, Williams, Carlson, Morton, and Dirksen.

Senator ANDERSON. This committee will come to order.

This morning we have a rather lengthy list of witnesses and I would hope the 15-minute time limitation to testify will be honored.

The first witness is Mr. John H. Perkins of the American Bankers Association. Will you come forward and proceed, sir. I am sorry other members of the committee are not here as yet, but we all have double assignments today. But we will be glad to have you go ahead.

STATEMENT OF JOHN H. PERKINS, REPRESENTING THE AMERICAN BANKERS ASSOCIATION

Mr. PERKINS. My name is John H. Perkins. I am senior vice president of the Continental Illinois National Bank & Trust Co. of Chicago. I am appearing here today to present the views of the American Bankers Association on H.R. 13103, the Foreign Investors Tax Act of 1966. This act carries out a number of the recommendations contained in the Fowler task force report for the purpose of encouraging foreign investment in the United States. Secretary Fowler emphasized this objective again Monday, and we support this. However, the act contains two provisions of vital concern to commercial banks, and to the well-being of our country. These provisions do not have any bearing upon taxes paid by commercial banks under our tax laws, and are not based on recommendations of the Fowler task force. In fact, they run counter to the objectives of the task force report.

The act proposed to amend the Internal Revenue Code to subject to the U.S. income tax, interest paid to nonresident aliens and foreign corporations on their U.S. bank deposits. This tax would become effective after 1971. The act also would include deposits in U.S. banks in the gross estate of nonresident aliens and subject such deposits to the U.S. estate tax. Presently, interest paid to nonresident aliens and foreign corporations not doing business in the United States on U.S. bank deposits is not subject to the U.S. income tax and neither are the deposits of nonresident aliens subject to the U.S. estate taxes.

In presenting H.R. 13103 to the House of Representatives for its consideration, the chairman of the Committee on Ways and Means reported that the original purpose of this legislation was to improve the U.S. balance of payments, but the committee concluded that the tax laws needed change. The bill as modified by the Ways and Means Committee was primarily designed to treat nonresident aliens and corporations generally on a basis which is consistent with the tax treatment of American citizens and domestic corporations.

We believe that enactment of the two provisions in the act referred to above will do irreparable injury to the economic position of the United States. If these provisions are enacted, undoubtedly there will be a widespread withdrawal of foreign dollar balances from this country. This will add to the problems brought on by our balance-of-payments position and will result in substantial additional outflow of gold from the United States. Any assumption that delay in the effective date in the imposition of income taxes until after 1971, postpones immediate concern is erroneous. I think I would like to emphasize that, that the very passing of that act will trigger a reappraisal of banking relationships by the nonresident aliens affected. This reappraisal will lead to near-term action in many cases. As a matter of fact, commercial banks already are receiving inquiries from their foreign depositors concerning the pending legislation. Also, the estate tax on foreign held deposits would be effective at once, that is, with respect to taxable years beginning after December 31, 1966. Consequently, if the legislation is enacted there could possibly be a massive outflow of funds before the end of the year which could seriously affect our international financial position for this year. On the basis of transactions during the first half of this year, our payments position, without taking into consideration any movement of funds that may result under this legislation, will be much more unfavorable than originally anticipated at the beginning of the year. I might add too any outflows triggering from the passage of this act would take effect immediately, whereas the benefits from the other parts of the act would take some time to affect our position.

The action proposed in the pending legislation is inconsistent with previous action by the Congress in dealing with foreign bank deposits in this country. The importance of retaining such funds in this country from the standpoint of our balance of payments and U.S. gold position was considered an important factor by the Banking and Currency Committee in its report on H.R. 5306, 89th Congress, 1st session (Rept. No. 336), a bill to continue the authority of domestic banks to pay interest on time deposits of foreign governments at rates differing from those applicable to domestic depositors. The committee, in recommending passage of H.R. 5306, stated that "the object of the bill is to extend existing provisions of law designed to encourage foreign governments and monetary authorities to maintain dollar accounts in this country rather than convert these dollar accounts directly into gold or to transfer the funds to other financial centers, whereupon they could be acquired by official institutions of other countries and be converted into gold."

Bringing our international payments into balance is difficult, particularly in light of the present magnitude of U.S. Government commitments in support of world peace and development. As an emergency expedient, American businessmen and bankers have been enlisted in a voluntary program of restraints on U.S. capital outflow to eliminate the deficits. This effort should not be undermined by introducing penalties on foreign deposits with American banks. The original proposal of tax legislation in this area at this time was to create a more attractive climate for foreign investments in the United States. Even the threat of the contemplated action is harmful, affecting foreigners' decisions to open or maintain accounts with American banks.

In addition to the effect which the withdrawal of foreign balances could exert on our balance-of-payments position, there is also the effect on our general economic position. Balances in U.S. banks maintained by nonresident aliens represent assets that have been voluntarily brought into this country for one reason or another, but usually from the standpoint of safety. The U.S. dollar is, and has been for many years, the strongest currency in the world, and this has lead foreigners to transfer part of their wealth to the United States for safekeeping. This has been encouraged because such assets in the form of bank deposits have not been subject to our estate taxes; the income on such deposits has not been subject to our income taxes, and there are no impediments to the withdrawal of the deposits from the United States.

We do not have precise figures available which show the aggregate amount of the funds currently on deposit, but it is conservatively estimated that they amount to several billions of dollars, which I think our figures are consistent with those which have been given in the last few days here.

Senator ANDERSON. It is substantially higher, isn't it? We had testimony earlier of about a billion nine-hundred million dollars.

Mr. PERKINS. As I understand it, Senator, that was in reference to New York City alone.

Senator ANDERSON. Most of the money is there, isn't it?

Mr. PERKINS. Well, I think there is quite a bit more, as we point out here, where these funds are not only held in the large banks in the principal money centers of the country, which do an extensive business in support of our foreign trade, but they are also held by many of the smaller banks throughout the country, and especially by the banks in the border States.

In the last few days, incidentally, we made some checks around on an informal basis and we found deposits of this type while admittedly not quite the biggest dollar amounts but spread all over, Atlanta, Boston, Chicago, Cincinnati, Cleveland, Dallas, El Paso, Fort Worth, Houston, Jacksonville, Phoenix, Philadelphia, St. Louis. It is very widespread.

We know for a fact that a number of Texas banks, for example, especially those located near the border, have substantial deposits from residents in Mexico. One such bank reports that one-quarter of its total deposits of $40 million would be included in this category. So again in answer to your question, it is very important to these banks even though the dollar amounts are quite different in magnitude.

Senator ANDERSON. I want you to testify on this point because that is a question we will face very shortly. I talked to Sam Young of the bank in El Paso—I have known him for many years; a very fine man and a very fine bank—and he tells me that he has substantial deposits from across the border. That is true clear across the Mexican borderline and I think that was an important fact which had not been brought out the other day in the testimony. It isn't confined to the New York banks, in other words.

Mr. PERKINS. I couldn't agree with you more. That is what I am trying to emphasize, that while the very large dollar amounts may be in some of the New York banks and one or two others around the country, in Chicago and San Francisco, there are very important dollar amounts elsewhere and to the individual banks elsewhere, particularly in along both the borders, these are very important amounts to those banks and I think would have a very substantial effect on the operations of those banks.

Senator CARLSON. Mr. Chairman, right on that point, Mr. Perkins, who represents The American Bankers here, we disputed this figure of $1.9 billion, $1.9 billion in New York. Would you be willing to estimate a guess as to what we have in this country?

Mr. PERKINS. I think it would be very hard to guess. We are trying, through the Reserve City Bankers Association to get some more accurate figures, but we don't have those available yet. I understand Secretary Fowler used a figure of about $2.5 billion as the total dollar amount. This would presumedly then say there is roughly $600 million of this type of money spread elsewhere. I don't think this is an unreasonable figure. My own guess would be that if we added not only the nonresident alien deposits, but we got into some of these estate matters and others, my guess would be it would be larger than the $600 million, if we got all the figures together, but I just don't know.

Senator CARLSON. Larger than $600 million, in addition to the $1.9 billion?

Mr. PERKINS. Yes, sir.

Senator CARLSON. That would be $3.5 billion, a little better than that.

Senator ANDERSON. Senator Carlson, all along the border there are banking institutions that do business in Mexico. I know the El Paso banks do a lot of business.

Mr. PERKINS. For example, Senator, taking this one bank I referred to, a $40 million bank. He has got $10 million in his $40 million bank alone. Well, you can imagine what the impact would be on his bank of such a tax bite. Also I think that is indicative of the kind of money that is around that is not normally thought of.

This particular bank is in a little Texas town where you would not expect this kind of money at all, of that size.

Senator ANDERSON. I am glad you cleared up that point because it was bothering some people.

Mr. PERKINS. Well, I have been impressed in our informal survey just how many cities this does affect. It is not just Miami and New Orleans and a few of the larger cities but it is widespread, and even in areas like Pittsburgh that have this kind of deposit.

I go on. Many of the resources of agencies in the United States are being utilized to encourage the expansion of our export business in order to strengthen our balance-of-payments position. Our American banks and industry have wholeheartedly supported efforts of the administration to increase our exports and to reduce the amount of American investments abroad. Withdrawal of balances of nonresident aliens might well exert some indirect adverse effect on our export trade. Although it is obviously difficult to pinpoint this with certainity.

We believe that on balance, the United States has a great deal more to lose than can ever be gained from what little taxes that might be collected under the pending legislation from these sources because, as pointed out above, owners of these funds are free to move them elsewhere. Legislation of this character is apt to have an unwholesome immediate effect on investor psychology and we can look to a prompt outflow of funds seeking investment outlets in other countries. It is recognized that the act provides that the amendments made by it are not to apply where application would be contrary to any treaty obligation of the United States and that there is a 5-year period before the income tax would be effective on bank deposits. However, this is offset by the immediate imposition of the estate tax. And I would like to add it is offset by the immediate psychological effect on these foreigners who already are concerned about this and who will not wait, in our opinion, until 1971 at all to make their moves.

Accordingly, we strongly recommend that the committee amend the act and retain the present provisions of the Internal Revenue Code which exempts from the U.S. estate and income taxes deposits held by nonresident aliens in U.S. banks and the interest paid thereon.

Senator ANDERSON. Thank you, Mr. Perkins. Is there any possibility that the banks might feel differently if the estate tax provision was postponed until 1972?

Mr. PERKINS. I don't believe so, Senator. Our feeling, and we have talked to a number of bankers about this in a number of areas, our feeling is quite strong that the banking relationship is built up over a long period of years. When a new tax comes in, whether it is the estate tax or the deposit tax, the people owing the funds and their lawyers and their financial advisers and all start looking at this, start worrying about it and they don't think of waiting until that day in 1971. They start trying to analyze whether or not they ought to change their banking relationships because of this tax, and if they conclude to do that, they will go ahead and start making these moves now.

So, I don't think the idea of an effective date really has as much bearing as might seem from the date it is. In other words, we feel that this would trigger a certain amount of action immediately and not postpone action until 1971 when we could get another look. Obviously, there would be those who would wait until 1971 to make a move, I grant you that, but we think there would be some effects immediately and then over the next few years, month by month.

Senator ANDERSON. Since the House bill does not alter the present law permitting interest to be earned on income in foreign branches of U.S. banks without a tax being due, are there any large banks with foreign branches which might support this provision of the House bill? In other words, perhaps there is a divergence of opinion among your own people.

Mr. PERKINS. No; I think I can answer that unequivocally. Those who have foreign branches, the New York banks primarily, obviously they support that provision. We have foreign branches in our bank, we would not; we feel very strongly on this. I just don't see that at all. I think, incidentally, this is one point that needs making, that while those banks having foreign branches maybe could conteract some of the impact of this, the fact is that is a very small group of banks, and the banks we were talking about along the border and elsewhere throughout the country do not have foreign branches and would have no way to recoup any of these funds through a branch operation.

Senator ANDERSON. I referred a while ago to Mr. Young and his bank in El Paso. He has been a longtime friend and director of Mr. Hilton's hotel operations. Because he came out of that country and I would have thought that Mr. Young's interests were in oil and cotton and some hotel business. But he was very definite in the amount of money that his bank had and other banks along the border had, and he thought this was a great disservice to those banks. You think your membership will so testify?

Mr. PERKINS. Yes.

Senator ANDERSON. Senator Carlson.

Senator CARLSON. Mr. Perkins, yesterday when Mr. Barth testified, in his statement he had a paragraph or two that dealt with some of the restrictions that are placed on the movement of this money by the Federal Reserve, and he mentioned, his direct statement was, there were some very rigid, I believe, restrictions on the handling of this foreign credit.

I have here before me the Federal Reserve Bulletin of December 1965, and in it, page 1683, there is an article entitled "Revised Guidelines," and I shall read one or two paragraphs and then ask permission to put it in—it is just a short article—in the record of the hearings.

The main feature of the guidelines for 1965 has been a percentage limitation on increases in foreign credits from the base date of December 31, 1964. In general each bank was requested to restrict its foreign credits outstanding to an amount not in excess of 105 percent of the amount outstanding at the end of 1964, and each non-bank financial institution was requested to operate within a framework roughly similar to that suggested for the banks.

Now I assume the bankers have been following this, and——

Mr. PERKINS. I think the bankers have been following it very well. As a matter of fact, I think the total amount of this credit is actually below the maximum permitted by the guidelines, and I think the banking industry, in response to the Government's voluntary restraint program, of which these guidelines are a part, have had complete compliance.

I think Governor Martin and Governor Robertson have so testified at a number of House and Senate hearings. I think their record is very good on this.

Senator CARLSON. For the record, the next one paragraph:

Continued restraint on the increase in foreign credits is a basic objective of the bank program for 1966. Generally speaking, commercial banks are requested to restrain any expansion in foreign credits to such an extent that the amount outstanding at year end will not exceed 109 percent of the amount outstanding on December 31, 1964.

I wanted this as a part of the record.

Senator ANDERSON. It will be put in the record.

Senator CARLSON. Thank you very much.

(The article referred to follows:)

[From the Federal Reserve Bulletin, December 1965]

BALANCE OF PAYMENTS PROGRAM—REVISED GUIDELINES FOR BANKS AND NONBANK FINANCIAL INSTITUTIONS

Since the inception of the voluntary foreign credit restraint effort, immediately following announcement by the President of his balance of payments program in February 1965, commercial banks and other financial institutions have contributed substantially to the improvement in the nation's payments position. This has been accomplished by the high degree of cooperation and statesmanship exhibited by the financial community in restraining the growth of (and in some instances reducing) claims on foreigners in accordance with guidelines issued by the Board of Governors of the Federal Reserve System.

Although considerable progress has been made and although the voluntary restraint program is temporary in nature, perseverance by financial institutions in the program through 1966 is necessary to attain the goal of equilibrium in the nation's balance of payments and represents the appropriate response to the President's message of February 10, 1965, in which he issued a personal "call on American businessmen and bankers to enter a constructive partnership with their Government to protect and strengthen the position of the dollar in the world today."

The main feature of the guidelines for 1965 has been a percentage limitation on increases in foreign credits from the base date of December 31, 1964. In general, each bank was requested to restrict its foreign credits outstanding to an amount not in excess of 105 per cent of the amount outstanding at the end of 1964, and each nonbank financial institution was requested to operate within a framework roughly similar to that suggested for banks.

For the year 1966 the guidelines for both banks and nonbank financial institutions have been revised to suggest limitations on expansion of foreign credits that are comparable to the limitations suggested for 1965. These will permit some further expansion in such credits, and provide for variations to remove certain inequities inherent in the 1965 program.

Nothwithstanding the fact that the banking system as a whole is presently well below the suggested target for 1965, this additional expansion has been allowed for two reasons: (1) it is believed that banks will continue to cooperate with the spirit as well as the letter of the program and will utilize the expansion suggested only to the extent needed to meet priority credit requirements; and (2) it is intended to make certain that export financing is available in adequate amounts, and that the bona fide credit needs of less developed countries will continue to be met.

Continued restraint on the increase in foreign credits is the basic objective of the bank program for 1966. Generally speaking, commercial banks are requested to restrain any expansion in foreign credits to such an extent that the amount outstanding at year-end will not exceed 109 per cent of the amount outstanding on December 31, 1964. Further, in order to spread throughout the year any outflow necessary to meet priority credit requirements, it is requested that the amount outstanding not exceed 106 per cent of the 1964 base during the first quarter, 107 per cent during the second, and 108 per cent during the third quarter. Special consideration for banks with small bases will add 1 per cent or less to the total, bringing the potential amount outstanding at the end of 1966 for the banking system as a whole to about 110 per cent of the 1964 base as compared with the 105 per cent target for 1965.

The guidelines for 1966 for nonbank financial institutions have been revised to reflect provisions broadly comparable with those of the bank guidelines. Investments of liquid funds abroad are to be held to minimum practicable levels and ordinarily should not be permitted to exceed the reduced September 30, 1965, total. Investments in credits maturing in 10 years or less and in foreign branches and financial subsidiaries are subject to the same ceiling as suggested for the banks. Long-term investments in developed countries other than Canada and Japan are subject to a ceiling of 105 per cent of the September 30, 1965, amounts during 1966; this base was selected because retroactive use of a 1964 year-end base might have been inequitable for some institutions.

As in 1965, financial institutions are requested to give priority to export credits and credits to less developed countries. In instances where the special base and ceiling calculations for banks with small bases result in a ceiling in excess of 109 per cent, it is requested that the amount in excess of 109 per cent of a bank's base be used exclusively for such priority credits. The leeway for additional foreign credits provided by the 1966 guidelines plus the funds available from repayments on outstanding credits will provide larger resources than last year to finance an expanded volume of exports and to satisfy credit requirements of less developed countries.

The guidelines for banks and nonbank financial institutions follow.[1]

Guidelines for Banks

(1) Base, Ceiling, and Reporting

(a) Base

1. The base is a bank's total claims on foreigners for own account, including foreign long-term securities, on December 31, 1964, except for the exclusion in (a) 3 below.

2. Meaning of terms:

(A) "Foreigners" include individuals, partnerships, and corporations domiciled outside the United States, irrespective of citizenship, except their agencies or branches within the United States; branches, subsidiaries, and affiliates of U.S. banks and other U.S. corporations that are located in foreign countries; and any government of a foreign country or official agency thereof and any official international or regional institution created by treaty, irrespective of location.

(B) "Long-term securities" are those issued without a contractual maturity or with an original maturity of more than 1 year from the date of issuance.

(C) "Other claims" include all long-term claims other than securities, real assets, net investment in and advances to foreign branches and subsidiaries, and all short-term claims (such as deposits, money market instruments, customers' liability on acceptances, and loans).

3. Specific inclusions and exclusions:

(A) Claims on foreigners should be included without deduction of any offsets. Foreign customers' liability for acceptances executed should be included whether or not the acceptances are held by the reporting bank. Participations purchased in loans to foreigners (except participations in loans extended by the Export-Import Bank) also should be included.

(B) Contingent claims, unutilized credits, claims held for account of customers, acceptances executed by other U.S. banks, and participations in loans arranged by or guaranteed by the Export-Import Bank or insured by the Foreign Credit Insurance Association should be excluded.

(b) Ceiling

1. The 1966 ceilings with respect to the amount of foreign credits outstanding by a bank with a base of $5 million or more are as follows:

(A) In the first calendar quarter, 106 per cent of its base;

(B) In the second calendar quarter, 107 per cent of its base;

(C) In the third calendar quarter, 108 per cent of its base;

(D) In the fourth calendar quarter, 109 per cent of its base.

2. In lieu of the ceiling prescribed in (b) 1 above, a bank with a base of $500,000 but less than $5 million, may use the following special ceiling:

(A) In the first calendar half, its base plus $225,000;

(B) In the second calendar half, its base plus $450,000.

3. The ceiling for a bank with a base below $500,000 is 150 per cent of its base. However, any such bank, or a bank which had no foreign credits outstanding on December 31, 1964, may discuss with the Federal Reserve Bank of the Reserve district in which it is located the possibility of adopting a ceiling that would permit expansion up to $450,000 above the bank's base.

4. In discussing the ceiling of a bank described in paragraph 3, the Federal Reserve Bank will ascertain the bank's previous history in foreign transactions, including acceptance of foreign deposits or handling foreign collections, and the reasons why the bank considers it should have additional leeway.

---

[1] Previous Guidelines for Banks and Nonbank Financial Institutions were published in the following Bulletins this year: March, pp. 371–76; April, p. 532; May, p. 685; July, pp. 944–46; and August, p. 1105.

Prior to a decision, the Federal Reserve Bank will obtain clearance from the Board of Governors.

5. Any expansion under paragraphs 2 or 3 that is in excess of 109 per cent of the bank's base should be limited to loans or acceptance credits that finance exports of U.S. goods or services or that represent credit extended to less developed countries. Export credits should be limited to transactions orginated by the bank's regular customers or by residents of its normal trade territory. Such expansion should not involve (A) participations in loans originated by other banks or purchases of such loans, (B) investments in foreign securities, (C) deposits in foreign barks, or (D) investments in foreign short-term money market instruments.

(c) *Reporting*

1. Banks that report on Treasury Foreign Exchange Form B–2 or B–3 should file a Monthly Report on Foreign Claims (Form F.R. 391) with the Federal Reserve Bank of the Reserve district in which the bank is located.

2. Banks that have claims on foreigners in an amount of $100,000 or more and do not report on Treasury Foreign Exchange Form B–2 or B–3 should file a Quarterly Report on Foreign Claims (Form F.R. 391a) with the Federal Reserve Bank of the Reserve district in which the bank is located.

3. Copies of Forms F.R. 391 and 391a are available at the Reserve Banks.

(2) LOANS INVOLVING EXPORT-IMPORT BANK

Participations in individual export loans arranged by the Export-Import Bank, loans with Export-Import Bank guarantees or insurance, and holdings of "Export-Import Portfolio Fund" participations are excluded from the ceiling. The role of the Export-Import Bank within the framework of the President's program is coordinated by the National Advisory Council for International Monetary and Financial Problems.

(3) CREDITS IN EXCESS OF CEILING

A bank would not be considered as acting in a manner inconsistent with the program if it at times exceeds its ceiling as a result of the (a) drawdown of binding commitments entered into before February 11, 1965; or (b) extension of priority export credits.

The bank should, however, reduce its claims on foreigners to an amount within the ceiling as quickly as possible. It should also take every opportunity to withdraw or reduce commitments, including credit lines, that are not of a firm nature and to assure that drawings under credit lines are kept to normal levels and usage. At time of renewal, each credit line should be reviewed for consistency with the program.

A bank whose foreign credits are in excess of the ceiling will be invited periodically to discus with the appropriate Federal Reserve Bank the steps it has taken and proposes to take to reduce its credits to a level within its ceiling.

(4) LOAN PRIORITIES

Within the ceiling, absolute priority should be given to bona fide export credits. Credits that substitute for cash sales or for sales customarily financed out of nonbank or foreign funds are not entitled to priority.

With respect to nonexport credits, banks should give the highest priority to loans to less developed countries and should avoid restrictive policies that would place an undue burden on Canada, Japan, and the United Kingdom.

It is expected that the outstanding amount of nonexport credits to developed countries in continental Western Europe would not be increased during 1966 but rather would be reduced to the extent needed to meet bona fide requests for priority credits within the over-all ceiling.

Without attempting to specify all types of loans that should be restricted, it is obvious that credits to developed countries that can be cut back with benefit to our balance of payments and with the least adverse side-effects include: credits to finance third-country trade, credits to finance local currency expenditures outside the United States, credits to finance fixed or working capital needs, and all other nonexport credits to developed countries that do not suffer from balance of payments difficulties.

(5) BANKS WHOSE FOREIGN CREDITS CONSIST ALMOST ENTIRELY OF EXPORT CREDITS

A bank whose foreign credits are consistently composed almost entirely of export credits usually should keep its credits within its ceiling. If such a bank exceeds its ceiling from time to time, it would not be considered as acting in a manner inconsistent with the program if the amount of such excess is reasonable and the bank makes every effort to bring the amount of its credits back within the ceiling at the earliest practicable date.

(6) TRUST DEPARTMENTS

Trust departments of commercial banks should follow the guidelines with respect to nonbank financial institutions.

(7) TRANSACTIONS FOR THE ACCOUNT OF CUSTOMERS

A bank should bear in mind the President's balance of payments program when acting for the account of a customer. Although the bank must follow a customer's instructions, it should not encourage customers to place liquid funds outside the United States. A bank should not place with a customer foreign obligations that, in the absence of the voluntary credit restraint program, it would have acquired or held for its own account.

(8) FOREIGN BRANCHES

The voluntary credit restraint program is not designed to restrict the extension of foreign credits by foreign branches if the funds utilized are derived from foreign sources and do not add to the outflow of capital from the United States.

Total claims of a bank's domestic offices on its foreign branches (including permanent capital invested in as well as balances due from such branches) represent bank credit to nonresidents for the purposes of the program.

(9) "EDGE ACT" CORPORATIONS

"Edge Act" and "Agreement" corporations are included in the voluntary credit restraint program. Foreign loans and investments of such corporations may be combined with those of the parent bank or a separate ceiling may be adopted for the parent bank and each such subsidiary corporation. If such corporation is owned by a bank holding company, its foreign loans and investments may be combined for purposes of the program with any one or all of the banks in the holding company group.

An "Edge Act" corporation established before February 10, 1965, that had not made any significant volume of loans and investments before December 31, 1964, may take as a base, alone and not in combination with its parent, its paid-in capital and surplus, up to $2.5 million.

(10) U.S. BRANCHES AND AGENCIES OF FOREIGN BANKS

Branches and agencies of foreign banks located in the United States are requested to act in accordance with the spirit of the domestic commercial bank voluntary credit restraint program.

(11) LOANS TO U.S. RESIDENTS AND SUBSTITUTION OF DOMESTIC CREDIT FOR CREDIT FROM FOREIGN SOURCES

There are a number of situations in which loans to domestic customers may be detrimental to the President's balance of payments program. These include:

(A) Loans to U.S. companies which will aid the borrower in making new foreign loans or investments inconsistent with the President's program. Banks should avoid making new loans that would directly or indirectly enable borrowers to use funds abroad in a manner inconsistent with the Department of Commerce program or with the guidelines for nonbank financial institutions.

(B) Loans to U.S. subsidiaries and branches of foreign companies which otherwise might have been made by the bank to the foreign parent or other foreign affiliate of the company, or which normally would have been obtained abroad.

(C) Loans to U.S. companies with foreign activities that take the place of credit normally obtained abroad. Even though such loans are made to domestic firms or those domiciled here, the impact on the U.S. balance of payments is the same as if the bank had made loans to foreigners in the first instance.

To the extent possible, banks should also avoid making loans to domestic borrowers that have an effect similar to that of the loans described in paragraphs (B) and (C) above.

(12) MANAGEMENT OF A BANK'S LIQUID FUNDS

A bank should not place its own funds abroad for short-term investment purposes, whether such investments are payable in foreign currencies or in U.S. dollars. This does not, however, call for a reduction in necessary working balances held with foreign correspondents.

GUIDELINES FOR NONBANK FINANCIAL INSTITUTIONS

The types of financial institutions to which these guidelines on foreign lending and investing are applicable include domestic life, fire and casualty insurance companies; corporate noninsured pension funds and State-local retirement systems; mutual savings banks, mutual funds and investment companies; consumer, sales and commercial finance companies; college endowment funds and charitable foundations. Also covered by the program are the U.S. branches of foreign insurance companies and of other foreign financial corporations. Trust companies and trust departments of commercial banks are expected to observe the guidelines in the investment of funds entrusted to them or for which they serve as investment advisor. Investment underwriting firms, security broker and dealers, and investment counseling firms are also covered with respect to foreign assets held for their own account, and are requested to inform customers of the guidelinesc and to enlist their support in cooperating with the President's program.

Any nonbank financial institution holding $500,000 or more in foreign loans, investments, or other foreign financial assets is requested to file a statistical report (Form F.R. 392) at the close of each calendar quarter with the Federal Reserve Bank of the Reserve district in which its principal office is located. Lending institutions not receiving copies of the reporting form may obtain them from the Federal Reserve Bank.

SPECIFIC GUIDELINES

(1) Investment of liquid funds abroad should be reduced to minimum practicable levels consistent with the operating needs of the institution. Such holdings ordinarily should not be permitted to exceed the September 30, 1965, total, except for temporary seasonal excesses.

This category includes all deposits held with foreign banks or foreign branches of U.S. banks, whether denominated in U.S. dollars or a foreign currency and regardless of maturity. It also includes all liquid money market claims on foreign obligors with an original maturity of 1 year or less, whether such claims are denominated in U.S. dollars or a foreign currency. The term "liquid money market claims" is interpreted broadly to include the securities of Governments and their instrumentalities, commercial paper, finance company paper, bankers' acceptances, and other readily marketable paper. This guideline is *not* applicable to short-term business credits that are not readily marketable (covered under guideline (2)).

(2) Investments and credits maturing in 10 years or less at date of acquisition, except for liquid investments covered under guideline (1), are subject to a percentage guideline based on the total of such holdings at the end of 1964. The aggregate amount of these investments, and of net financial investment in foreign branches, financial subsidiaries and affiliates (described below), should not exceed 105 percent of the 1964 base date amount as of the end of 1965, and should not exceed 106 per cent of the base date amount during the first quarter of 1966, 107 per cent during the second quarter, 108 per cent during the third quarter, and 109 per cent in the final quarter of the year.

This category includes all bonds, notes, mortgages, loans, and other credits carrying maturities at date of acquisition of 10 years or less. The date of final maturity is to be taken in classifying individual credit transactions, except that a credit transaction should not be classified as "long term" (and hence subject to guideline (3) below) unless 10 per cent or more of the amount to be repaid is scheduled to be repaid *after* 10 years. Loans guaranteed or arranged by the Export-Import Bank or insured by the Foreign Credit Insurance Association are not to be considered foreign credits for purposes of this program.

Net financial investment in foreign branches, financial subsidiaries and affiliates, if any, is included among the assets subject to the percentage ceilings of this guideline. Such financial investment includes payments into equity and other capital accounts of, and net loans and advances to, foreign corporations engaged principally in finance, insurance, or real estate activities, in which the U.S. institution has an ownership interest of 10 per cent or more. Earnings of a foreign affiliate that are reinvested in the business are not included among assets subject to the guideline ceiling, although institutions are requested to repatriate such earnings to the fullest extent feasible.

In administering restraint in foreign lending and investing, institutions are requested to observe the following priorites or guides:

1. Credits and investments that represent bona fide U.S. export financing should receive absolute priority.

2. Nonexport credits and investments in the less developed countries, and investments in the securities of international institutions, are to be given priority consideration second only to bona fide export financing.

3. The flow of investment funds to Canada and Japan, which are heavily dependent on U.S. capital markets, need be restricted only to the extent necessary to remain under the guideline ceiling.

It is recognized that some individual institutions may temporarily exceed the guideline ceiling, because of investments made under the first two priorities above, or the taking down of firm commitments to lend or invest entered into prior to June 22, 1965, the effective date of the previous guidelines. In any such case, an institution that exceeds its target should consult with the Federal Reserve Bank of the Reserve district in which it is located regarding a program for moving back within the ceiling in a reasonable period of time.

(3) Long-term credits (exceeding 10 years in maturity) and stock investments in foreign companies are not subject to an aggregate ceiling for 1966. This category includes bonds, notes, mortgages, loans, and other credits maturing more than 10 years after date of acquisition, as well as preferred and common stocks. (Loans and investment in certain subsidiaries and affiliates, however, are covered by guideline (2).) Term loans and serial-payment notes and bonds are included in this category *only if* 10 per cent or more of the total amount of the credit is scheduled for repayment to the lender after 10 years beyond date of acquisition.

No percentage ceiling is suggested on long-term credits and investments in the priority categories relating to export financing and to less developed countries (including international institutions) as described in guideline (2). Long-term investment in Canada and Japan also is not subject to a percentage ceiling, in view of inter-Governmental agreements affecting the net amount of financing done by these countries in U.S. financial markets. Lending institutions are requested, however, to limit in 1966 the total of credits and investments in other developed countries to an amount not in excess of 105 per cent of the amount of such holdings on September 30, 1965. Within this category, institutions are expected to avoid any increase in long-term investments in the developed countries of continental Western Europe.

The attention of lending institutions is directed to the need to refrain from making loans and investments inconsistent with the President's balance of payments program. Among these are the following:

1. Long-term credits covered by guideline (3) which substitute for loans that commercial banks would have made in the absence of the voluntary foreign credit restraint effort administered by the Federal Reserve System.

2. Credits to U.S. borrowers which would aid in making new foreign loans or investments inconsistent with the voluntary restraint program administered by the Department of Commerce.

3. Credits to U.S. subsidiaries and branches of foreign companies which otherwise might have been made to the foreign parent, or which would substitute for funds normally obtained from foreign sources.

4. Credits to U.S. companies with foreign activities which would take the place of funds normally obtained abroad.

Reasonable efforts should be made to avoid accommodating credit requests of these types, regardless of specific guideline targets detailed in this circular.

Notes

1. None of the guidelines in this circular are intended to apply to the reinvestment of reserves on insurance policies sold abroad in assets within the country involved, in amounts up to 110 per cent of such reserves.

2. Developed countries other than Canada and Japan are: Abu Dhabi, Australia, Austria, the Bahamas, Bahrein, Belgium, Bermuda, Denmark, France, Germany (Federal Republic), Hong Kong, Indonesia, Iran, Iraq, Ireland, Italy, Kuwait, Libya, Liechtenstein, Luxembourg, Monaco, Netherlands, Neutral Zone, New Zealand, Norway, Portugal, Qatar, Republic of South Africa, San Marino, Saudi Arabia, Spain, Sweden, Switzerland, and the United Kingdom.

Also to be considered "developed" are the following countries within the Sino-Soviet bloc: Albania, Bulgaria, any part of China which is dominated or controlled by international communism, Cuba, Czechoslovakia, Estonia, Hungary, any part of Korea which is dominated or controlled by international communism, Latvia, Lithuania, Outer Mongolia, Poland (including any area under its provisional administration), Rumania, Soviet Zone of Germany and the Soviet sector of Berlin, Tibet, Union of Soviet Socialist Republics and the Kurile Islands, Southern Sakhalin, and areas in East Prussia which are under the provisional administration of the Union of Soviet Socialist Republics, and any part of Viet Nam that is dominated or controlled by international communism.

Senator ANDERSON. Senator Dirksen.

Senator DIRKSEN. Mr. Perkins, how are you?

My attention was directed yesterday to the fact that the President's Task Force recommended that the tax on the estates of decedents, foreign decedents, be eliminated. Well, evidently, they also struck out two exemptions in the bill that go along with it. One of those made an exemption of corporate bonds, and the other made an exemption of cash in banks. Well, if that is the case, I can see very readily that they would want to haul their money out of the banks and they would want to liquidate their corporate bonds.

Now I believe somewhere along the line, although I have not seen it, that Secretary Fowler may have said that probably it would not amount to more than $5 million. Well, I have a letter which points out there has been a recent withdrawal in a Chicago bank of over $500,000, and one other withdrawal in which over $20 million would certainly be driven from this country if we didn't continue these exemptions in the law. Do you have a theory about it?

Mr. PERKINS. I really wonder whether the Secretary maybe was thinking of the amount of revenue from the tax, because clearly the amounts would be very large. This has been our position, Senator, particularly adding in the corporate bonds, but with the deposits, these are just large amounts of money, and these people are very responsive to taxes, and while some of them perhaps would, regardless of the tax, would keep their money in the United States for one reason or another, an awful lot of them would take some kind of steps to avoid the tax and the amounts involved I think clearly are just of very large magnitude, nothing like the $5 million you mentioned.

Senator DIRKSEN. Yes.

Mr. PERKINS. I had a call from one Chicago lawyer, as a matter of fact, who pointed out just one estate they were handling in their firm where there was $5 million of corporate bonds involved that would be moved.

Senator DIRKSEN. Another case that came to my attention was one from Latin America involving a very substantial sum.

Mr. PERKINS. I think in many ways, too, we are dealing—it is hard to pinpoint any of this. It is kind of a feel because we are dealing with areas where there are not precise figures available, where there are confidential relationships between banks and their customers, so it is hard to pinpoint, but what checking we can do indicates we are talking about large amounts of money.

Senator DIRKSEN. But it could be fairly assumed if that were the case and those two exemptions were eliminated, there would be every inducements to take their money out and also liquidate the bonds.

Mr. PERKINS. There would be every inducement to do it and it would be very easy to do it, particularly with bank deposits and even with the bonds that are well known bonds; that is right.

Senator DIRKSEN. And that, of course, would aggravate our balance-of-payments problem rather than help it.

Mr. PERKINS. This we feel very strongly and, as a matter of fact, I was trying to make the point earlier that the beneficial effects on the balance of payments to which the Secretary addressed himself Monday, would take time to develop because these are special technical provisions.

On the other hand, the immediate impact on the balance of payments, adverse impact, would be very sharp and very large because these people are free to move in many cases.

Senator DIRKSEN. Yes. Thank you.

Senator ANDERSON. Thank you very much, Mr. Perkins, for your statement.

Mr. PERKINS. Thank you.

(By direction of the Chair, the following communications are made a part of the record at this point:)

RHODE ISLAND HOSPITAL TRUST CO.,
Providence, R.I., July 7, 1966.

Hon. RUSSELL B. LONG,
Chairman of the Senate Committee on Finance
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: I understand that the "Foreign Investors Tax Act of 1966" HR 13103, is about to receive the active consideration of the Senate Committee on Finance.

Speaking for myself personally, as well as the Rhode Island Hospital Trust Company, we strongly oppose those provisions of the Bill which would impose income and inheritance taxes on certain foreign owned deposits in the United States, as there is no question in our minds that these provisions will seriously discourage non-residents from depositing in the U.S. Banking System. The loss of such deposits will, in our estimation, further compound the balance of payments position of the United States and, at the same time, impede our ability to serve as the financial center of the world. These provisions, we think, work more to the disadvantage of the inland banks in the United States, that those large banks located principally in New York which maintain overseas branches, in that a loss of such deposits in the United States must certainly flow to banks in other countries where we maintain no branches.

We at the Hospital Trust Company have vigorously supported the U.S. Government's Export Expansion efforts and have cooperated fully with the more recent Foreign Lending Guide Lines of the Federal Reserve System. Both of these programs are being specifically designed to represent the banking industry's contributions to a favorable solution of our balance of payments deficits. It would, therefore, be especially disturbing to us in the industry to see the benefits of our cooperation along these lines mitigated by the introduction of taxes whose end result must be detrimental to our international financial position.

Beyond this it seems to me that if the U.S. Government adopts the position provided for in the Foreign Investors Tax Act of 1966, we are adopting a position which is totally inconsistent with the role of the U.S. Dollar as a key World Currency.

I would appreciate your recognizing our views as your Committee considers the Foreign Investors Tax Act of 1966.

Thank you for your consideration.

Sincerely yours,

JOHN M. FRASER, Jr.,
Vice President and Manager.

WACHOVIA BANK & TRUST CO.,
Winston-Salem, N.C., August 4, 1966.

Re H.R. 13103—Foreign Investors Tax Act of 1966.

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

DEAR MR. CHAIRMAN: We understand that hearings on this bill are scheduled August 8 and 9. We submit this statement in lieu of a personal appearance and support the statements presented in person by representatives of the Bankers Association for Foreign Trade and the American Bankers Association.

Our International Department, established six years ago, has been successful not only in building business and earnings for the bank but also in assisting domestic companies to expand their export activities as a part of the Government's export promotion effort. As examples of the cooperation and assistance we have afforded the Government, the officer in charge of our International Department is a member of the Regional Export Expansion Council of the Department of Commerce, and our export promotion efforts won one of the first "E for Export" citations from President Kennedy. Although the foreign lending guidelines of the Federal Reserve System have reduced our potential for growth of business and earnings in export financing, we have recognized their need and have kept our foreign lending within the guidelines.

Estate and income taxes on foreign-owned deposits, as proposed in H.R. 13103, would, in our judgment, make the dollar a less desirable currency for foreign nationals and cause a great portion of these deposits to be transferred outside the United States. This flight would, without a doubt, reduce the deposit base, restrict the potential expansion of deposits and limit the earnings of our International Department, and we know of a number of other banks in similar circumstances Inevitably and unfortunately, this reduction would hamper further the ability of Wachovia and the other banks to expand the export financing activities that are vital to the Nation, particularly in view of the serious balance of payments problem which plagues the U.S. economy.

We are further concerned because the proposed taxes can so easily be avoided by transfer of the deposits to other countries. It seems to us unwise to impose taxes that not only will not accomplish the revenue purposes for which they are designed but will also drive business to foreign competitors of United States enterprises.

The transfer of deposits to avoid the taxes would be to the particular disadvantage of Wachovia and other banks like us which have no branches abroad to which our customers could move their deposits. The loss of these deposits would be further aggravated by the fact that business related to these deposits presumably would also be lost.

The transfer of deposits to avoid the taxes could, in itself, adversely affect the U.S. balance of payments and increase potential claims against the dwindling U.S. gold reserve. The purpose of this bill, as we understand it, is to create a more attractive climate for foreign investments in the United States; therefore, the deposit tax provisions would be contrary to the stated purpose of the bill of which they are a part. They would also appear to be inconsistent with previous actions by this Congress to encourage foreign dollar accounts in this country. Our balance of payments and gold reserve problems are of such significance and are so sensitive that we feel that our domestic economy would also suffer under the strains that these taxes would cause.

The transfer of deposits would also reduce a source of capital valuable to United States enterprises; less capital would mean reduced sources of domestic deposits and, consequently, a reduction in income already subject to tax.

For these reasons, therefore, we are opposed to H.R. 13103 as it passed the House of Representatives. We urge that the provisions imposing income and estate taxes on foreign-owned deposits in domestic offices of U.S. banks be eliminated from the bill. In our opinion, the present exemptions from these taxes are in the national interest and should be continued.

Respectfully,

WACHOVIA BANK & TRUST CO.
JOHN F. WATLINGTON, Jr.,
President.

INTERNATIONAL ECONOMIC POLICY ASSOCIATION,
Washington, D.C., August 5, 1966.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: We submit this statement for the consideration of your Committee's hearings on H.R. 13103, the Foreign Investors Tax Act of 1966. We wish to speak particularly to section 2(a)(1)(A) which extends the exemption from U.S. taxation on interest earned on foreign-held deposits in U.S. banks to savings and loan institutions and insurance companies, but provides that the exemption will cease to apply after December 31, 1971. We are concerned about the balance of payments implications of removing this exemption.

The International Economic Policy Association has made a detailed study of the United States balance of payments problem which was published June 13, 1966. The United States has had a deficit in its balance of payments in every year since 1950 with the single exception of 1957. These continuing deficits reached serious proportions in 1958 and have averaged more than $3 billion a year through 1964. Early in 1965 the Administration took steps to correct this problem which involved a program of voluntary restraints on U.S. private investment abroad. This resulted in some improvement in 1965 when the deficit was reduced to $1.3 billion. However, there is every reason to believe that the deficit this year will exceed the 1965 figure.

This serious problem results from the fact that the United States Government has assumed substantial commitments of an economic and military nature throughout the world. Meeting these obligations under those commitments requires the United States Government to expend huge sums abroad. These have consistently over the years exceeded the net amounts of foreign exchange earned by the private sector by substantial amounts. Given the long-range character of these commitments abroad, one cannot readily assume that this situation will change at an early date and our balance of payments improve. Any action suggested which may further aggravate the balance of payments deficits should be considered in this light.

The United States Government has, under the voluntary restraint program, asked U.S. companies with affiliates abroad to have the deposits of such affiliates brought back to the United States. The United States is also attempting to attract foreign capital to the United States. This is the original purpose of H.R. 13103. The proposal to tax foreign-held deposits in U.S. institutions would discourage efforts to attract foreign capital. Some capital might be withdrawn even prior to December 31, 1971. Certainly, thereafter, there will be a powerful disincentive to foreigners to hold their capital in U.S. banks.

In view of the seriousness of the balance of payments problem, and its long-range nature, we respectfully submit that this is not an appropriate time to withdraw the tax exemption from foreign-held deposits even prospectively after December 31, 1971. If, by 1970 or 1971, our balance of payments deficits should have been eliminated and we can anticipate no further serious difficulty, that would seem to us the time to consider such action.

Respectfully yours,

N. R. DANIELIAN, *President.*

STATEMENT SUBMITTED TO THE SENATE COMMITTEE ON FINANCE BY JACQUES APPELMANS, VICE CHAIRMAN, FOREIGN INVESTMENT COMMITTEE OF THE INVESTMENT BANKERS ASSOCIATION OF AMERICA

The Investment Bankers Association of America is comprised of approximately 717 organizations which underwrite, deal and act as brokers in all types of securities. The business of its members is primarily the raising of capital funds for industry, for new enterprises, and for governmental agencies by selling securities to investors both in this country and abroad. Its members also play a significant part in the secondary market for all such securities, both on the stock exchanges and over the counter. Their relations with foreign customers give them frequent opportunities to help improve the United States balance of payments by encouraging investment by foreign persons in securities issued by businesses or governments in the United States.

H.R. 13103 as passed by the House of Representatives on June 15, 1966, while eliminating some of the tax barriers to foreign investment in the United States, would continue one of the most serious barriers to investment in securities of U.S. issuers, namely, the imposition of estate taxes on nonresident aliens who die owning such securities. This is contrary to the recommendation of the Presidential task force headed by Henry H. Fowler before he became Secretary of the Treasury.

The Association can emphatically affirm, based on the experience of its members, the finding of the Fowler task force that U.S. estate taxes are "one of the most important deterrents in our tax laws to foreign investment in the United States." The task force recommended the elimination of all U.S. estate taxes on intangible personal property of nonresident alien decedents. Unfortunately, this important recommendation is not reflected in H.R. 13103 in its present form.

Most persons engaged in the securities business would agree that there are two features of the present tax laws which seriously deter investment in U.S. securities by foreign individuals, trusts and estates. These are (1) the progressive income tax rates applicable to nonresident aliens and foreign trusts and estates if the income derived from United States sources is greater than a certain amount ($21,200 beginning in 1965), and (2) the application of the Federal estate tax to nonresident alien decedents solely because of their ownership of U.S. securities.

The Fowler task force report recommended the elimination of both of these obstacles. H.R. 13103 in its present form would only eliminate the progressive income tax rates, but the Federal estate taxes would be retained. While the rate of the estate tax would be limited to a maximum of 25%, at the same time the estate tax base would be broadened by making bonds and other indebtedness of U.S. issuers, the certificates of which are physically located outside the United States, and deposits in U.S. banks subject to the estate tax for the first time. Thus H.R. 13103 would not only retain the existing estate tax barrier to foreign investments in U.S. stocks, but would extend it to bonds, debentures and other forms of indebtedness.

As explained in the Report of the Ways and Means Committee of the House, the 25% maximum estate tax rate was recommended primarily because nonresident aliens are not entitled to the 50% marital deduction. Any increase in foreign investment in this country would be only an incidental benefit. However, since the Federal estate tax is one of the two principal tax obstacles to investment by foreign persons in this country, the complete elimination of the estate tax provision should be seriously considered. The elimination of progressive income tax rates alone will not encourage foreign persons to invest in U.S. securities unless this barrier is also eliminated.

No tax avoidance loophole would be created by the elimination of intangibles from the estate tax provisions applicable to nonresident aliens. Since the present tax only applies to investments in U.S. securities, it can easily be avoided by the timely sale of U.S. securities owned by a foreign investor, except in the unfortunate cases where the investor meets death unexpectedly. Furthermore, as the Fowler task force report recognized, the present estate tax can legally be avoided, by foreign investors who can afford the proper advice and planning, by simply having their U.S. securities owned by a personal holding company which is incorporated abroad. Accordingly, while the reduction of the maximum Federal estate tax rate in the case of foreign persons owning U.S. property other than securities may be desirable for the reasons stated in the House Ways and Means Committee report, a complete exemption of securities and other intangibles from the Federal estate tax provisions applicable to nonresident aliens should also be enacted in order to encourage foreign investment.

The policy of not taxing intangibles owned by nonresidents has long been followed by many states of the United States. In the State of New York, this policy has been incorporated into the State Constitution for the specific purpose of encouraging nonresidents to use the investment facilities that exist in New York. This policy has helped greatly to make New York the financial center of the United States. The adoption of a similar policy in the U.S. Internal Revenue laws could assist in attracting investments to the United States and making the United States the fiananclal capital of the world.

A great many foreign countries, developed as well as underdeveloped, refrain from attempting to impose death taxes on securities issued by local companies which are owned by nonresidents, especially if the securities are transferable abroad, such as bearer securities physically located abroad. Some of these countries do not tax intangibles owned by nonresidents at all, regardless of where they are transferable or where they are physically located. A similar policy by the United States to encourage investment in this country is not out of line with the policy of other countries, but indeed only extends equal treatment to the residents of such countries. Furthermore, the small amount of U.S. estate tax collections attributable to intangibles owned by foreign persons suggests that the attempt to tax intangibles is not really effective. The removal of this deterrent to the use by foreign investors of the investment facilities offered by U.S. institutions would undoubtedly result in increased use of these facilities and have beneficial effects on the balance of payments.

The proposed extension of the estate tax to bonds and other debt instruments seems particularly inappropriate at the present time. Debt obligations of U.S. issuers are becoming more competitive in the international bond market due to the substantially increased yields that have developed recently, and this could attract new foreign investment to the United States which has previously been attracted to higher yielding foreign securities. The U.S. balance of payments could be improved significantly by such investment. While U.S. securities are already at a disadvantage because of the interest withholding tax, the imposition of the proposed estate tax would certainly make such securities unattractive to foreign investors. The top 25% rate is higher than the taxes imposed by some foreign countries on their own residents.

Because of the conflict with the U.S. balance of payments program, the estate tax should not be applied to debt instruments.

As an affirmative step toward encouraging investment in U.S. securities, the elimination or reduction of withholding taxes on interest payments, and possibly also dividends, should be considered. Precedent for the complete elimination of withholding taxes on interest and the reduction of withholding taxes on dividends may be found in many of the income tax treaties that the United States has with other countries.

CHICAGO, ILL., *August 5, 1966.*

Re H.R. 13103.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
United States Senate,
Washington, D.C.

DEAR SENATOR LONG: We respectfully request that this statement be incorporated in the hearings of the Finance Committee on H.R. 13103.

H.R. 13103 is "a part of the President's program to improve the U.S. balance of payments. The changes included in the proposed legislation were designed to stimulate foreign investment in the United States by modifying existing tax rules which are not consistent with sound tax policy and act as barriers to such investment." See House Report No. 1450, 89th Cong., 2d Sess.

A review of the provisions of H.R. 13103, coupled with an understanding of international financial practices, makes it clear that far from removing tax barriers to foreign investment, H.R. 13103 creates new barriers which are apt to result in an over-all worsening of the climate for foreign investment in the United States. H.R. 5916, the predecessor of H.R. 13103, while a move in the right direction, fell somewhat short of its goal.

H.R. 5916 was the Administration's original response to the published 1964 report of the President's Task Force on Promoting Increased Foreign Investment in United States Corporate Securities, which Task Force was headed by the then Under Secretary of the Treasury, Henry H. Fowler. The Task Force made its recommendations to the U.S. financial community and the U.S. Government for action to reduce the deficit in the U.S. balance of payments and defend U.S. gold reserves. The key recommendation for U.S. Government action calls for a revision of U.S. taxation of foreign investors. Recognizing that such revision is "one of the most immediate and productive ways to increase the flow of foreign capital to this country", the Task Force recommends the removal of "a number of elements in our tax structure which unnecessarily complicate and inhibit investment in U.S. corporate securities without generating material tax revenues".

The Task Force's two key tax recommendations are (1) elimination (with respect to income not connected with the conduct of a trade or business) of graduated taxation of U.S. source income of nonresident alien individuals and (2) elimination of U.S. estate taxes on all intangible personal property of nonresident alien decedents. With respect to the estate tax recommendation, the Task Force has this to say:

"U.S. estate taxes, especially as applied to shares of U.S. corporations owned by nonresident alien decedents (which are subject to U.S. estate taxes irrespective of whether they are held in this country or abroad) are believed to be one of the most important deterrents in our tax laws to foreign investment in the United States. U.S. estate tax rates are materially in excess of those existing in many countries of the world and, despite the treaties in effect with several countries, the taxes paid on a nonresident alien decedent's estate, some portion of which is invested in the United States, generally would be greater than those paid on a nonresident alien decedent's estate, no portion of which is invested in the United States. We understand that the revenues received by the United States as a result of estate taxes levied on intangible personal property in estates of nonresident alien decendents are not large."

H.R. 5916, introduced on March 8, 1965, was the administration's initial tax proposal based upon the Task Force recommendations. While proposing elimination of the graduated income tax on nonbusiness income of nonresident aliens, H.R. 5916 failed to follow the Task Force recommendation for complete elimination of the estate tax on intangible personal property. Instead, § 8 of H.R. 5916 substituted a new 5–10–15% rate schedule applicable to nonresident alien decedents. At the same time, however, § 8 made two adjustments to the nonresident alien decendent's estate tax base by (1) requiring the inclusion in the gross estate of all U.S. corporate and Government bonds and (2) treating all U.S. savings and loan deposits in the same manner as U.S. bank deposits, which under § 2105(b) of the Code are persently excluded from the nonresident alien decedent's gross estate.

Following hearings on H.R. 5916, at which the Treasury urged the Ways and Means Committee to support the bill and taxpayers argued for substitution of the Task Force estate tax recommendation for § 8, Congressman Mills introduced H.R. 11297 and then H.R. 13103, both of which were new versions of H.R. 5816.

Incredibly enough, H.R. 13103 might well be more appressive to nonresident aliens than is the case under existing law. While § 8 of H.R. 13103 proposes a new set of graduated estate tax rates for nonresident alien decendents ranging from 5% up to 25%, it also drastically broadens the estate tax base by requiring the inclusion, not only of U.S. corporate and Government bonds as proposed in H.R. 5916, but all U.S. bank deposits as well. The net results of H.R. 13103 would undoubtedly be the reduction of incentive to future foreign investment in the United States plus a withdrawal by nonresident aliens of substantial assets already invested here. These results would be the exact opposite of the stated purpose of the proposed legislation.

RATE SCHEDULE

It was made abundantly clear in the Task Force report and in Treasury testimony before the Ways and Means Committee on H.R. 5916 that the high U.S. estate tax rates currently in effect are a major deterrent to foreign investment in this country. Certainly nonresident aliens are not encouraged to invest in U.S. securities so long as U.S. estate tax rates are substantially higher than those prevailing in their own countries. Even the rates proposed by H.R. 5916 were conceded by the Treasury to be somewhat higher than those imposed upon resident estates in Switzerland, France, Germany, and the Netherlands. Any rate structure as high as the one proposed in H.R. 13103 would do little, if anything, to induce foreign investment, particularly from residents of the four countries mentioned above—the most prosperous countries in continential Europe. Foreigners are able to avoid high U.S. estate taxes entirely by not investing in this country or by investing indirectly through holding companies or foreign investment companies. If the goal of the Fowler Task Force is to be achieved, we must think in terms of inducing a substantial flow of capital to this country with less estate tax receipts per dollar of investment (though with substantially more capital paying a modest tax, the total estate tax receipts could well be higher). Trying to think in terms of whether a foreigner pays estate taxes at rates higher or lower than a U.S. citizen is unrealistic because the foreigner has the option of avoiding the tax entirely.

As matters now stand, the effective U.S. estate tax rates on estates of nonresident alien decedents are substantially higher than the corresponding rates on U.S. citizens utilizing the marital deduction. Mere reduction of the rates on nonresident alien decedents to a level comparable to those on U.S. citizens, such as H.R. 13103 proposes, provides no incentive to foreign investment. If Congress is unwilling to follow the Task Force recommendation for complete elimination of an estate tax on intangible personal property of nonresident alien decedents, then at the very least H.R. 13103 should be revised to provide an estate tax rate schedule certainly no higher than the 5–10–15% schedule proposed by H.R. 5916. This is the only way that the United States can hope to attract substantial investment by nonresident alien individuals. The annual estate tax revenue loss if the U.S. estate tax were made inapplicable to nonresident alien decedents' estates was estimated by the Treasury at $5,000,000. The annual revenue loss under H.R. 5916 was estimated by the Treasury at $3,000,000. These sums are negligible in comparison with the tremendous boost in foreign investment which could be expected by reason of elimination of the estate tax with respect to nonresident aliens' estates or a reduction of the rates to the levels of H.R. 5916.

THE LIKELY IMPACT OF ENLARGING THE ESTATE TAX BASE

Under the present law a nonresident alien may place his U.S. dollars in a U.S. bank account or place them in a foreign bank account and have the same estate tax consequences. If such deposits should become subject to estate taxes, it would be a simple matter indeed for the foreign depositor to avoid the tax by a transfer of funds. Undoubtedly this has been a principal reason why the exemption has existed since 1921. The international financial community has done business for years under the bank account estate tax exemption and the exemption of bonds located outside the country. Very large cash and bond balances have built up under these exemptions. Their elimination would certainly cause a dramatic exodus of capital from this country by simple transfers in the case of bank accounts and by tax-free sales and transfers of proceeds in the case of bonds. Removal of these long-standing exemptions would easily result in an immediate gold drain of hundreds of millions of dollars.

Furthermore, it cannot be the intention of H.R. 13103 to discourage foreign investment in U.S. bonds and savings accounts. This, however, is its effect. By removing the existing tax incentive, the efforts of the U.S. financial community to interest foreigners in such investments, to say nothing of retaining what is already invested here, would be seriously impaired.

It should be noted, incidentally, that H.R. 13103 purports to make one concession in determining the nonresident alien decedent's estate tax base. There would be excluded for an unlimited time "deposits in a foreign branch of a domestic corporation, if such branch is engaged in the commercial banking business and if such deposits are payable only in foreign currency". Correspondingly, interest income on such deposits would be treated as income from sources without the United States. These rules would apply regardless of whether the nonresident alien was engaged in business here. The significance, if any, of these provisions in attracting foreign investment has not been revealed either by the Ways and Means Committee or the Treasury. If it is believed that the provisions constitute such a marked liberalization of existing law as to require the severe estate tax rules of H.R. 13103 as a revenue loss counterbalance, then their revenue impact should be spelled out. It would appear, however, that these rather peculiar "concessions" have no real substance.

OTHER CONSIDERATIONS

The Task Force, in addition to recommendations for U.S. Government action, made a number of suggestions for action by the U.S. financial community. Testimony on H.R. 5916 brought out that the response by the private sector of the U.S. economy to the Task Force suggestions had been extremely encouraging. Failure by the Federal Government to respond directly and effectively to its challenge would create an extremely unfortunate picture. Enactment of § 8 of H.R. 13103 as now drafted would clearly indicate the Government's lack of confidence in the Task Force recommendations and a total failure to support the U.S. financial community in its renewed effort to attract foreign investment to this country.

The Task Force report cautioned that its tax recommendations were intended and conceived as a package and that the primary impact of the recommendations could be obtained only by adoption of the package. "To the degree that the package approach is discarded and the package is broken down into its components, some being accepted and others rejected, more of the potential impact will be lost than might necessarily be expected by analysis of the financial effect of any particular proposal." See Task Force report, p. 23. H.R. 5916 and H.R. 13103 propose to do exactly what the Task Force warned not to do. Failure to adopt the Task Force's estate tax recommendation and substituting a provision which, in the case of § 8 of H.R. 13103, could well have a detrimental net effect on our balance of payments, cuts the heart out of the Task Force's package of recommendations.

CONCLUSION

The Task Force has made well-considered proposals for revision of U.S. tax laws to encourage investment by nonresident aliens in U.S. securities. These proposals as a package represent a direct and dramatic effort to improve our balance-of-payments position. The revenue cost would be minimal. If the Task Force program is worth doing at all, it should be done completely and well. H.R. 5916 fell somewhat short of the Task Force recommendations, and H.R. 13103 is an essential failure in this respect.

Except for § 8, H.R. 13103 is a step in the right direction to provide added incentive for foreign investment in the United States through removal of U.S. tax deterrents to such investment. § 8, however, should be redrafted to provide for elimination of U.S. estate taxes on all intangible personal property of nonresident alien decedents. In other words, the Task Force estate tax recommendations should be adopted. If, on the other hand, Congress is unwilling to follow this recommendation in every detail, then rates comparable to or less than those incorporated in H.R. 5916 should be adopted, and § 8(c) and § 8(d) of H.R. 13103, which broaden the estate tax base, should be dropped.

Respectfully submitted.

HUBACHEK, KELLY, MILLER, RAUCH & KIRBY,
By DAVID E. DICKINSON.

Senator ANDERSON. Mr. Kalish.

STATEMENT OF RICHARD H. KALISH, PARTNER, PEAT, MARWICK, MITCHELL & CO.

Mr. KALISH. Mr. Chairman, Senator Carlson, Senator Dirksen, my name is Richard Kalish. I am a partner in the firm of Peat, Marwick, Mitchell & Co. We represent many firms doing business in the United States. My testimony is being made on behalf of our clients and also on behalf of Mr. James Burke, also a partner in the firm of Burke & Burke, attorneys for clients having a common cause with that of our clients.

Senator ANDERSON. Just a second, Mr. Counsel. Do you plan to present all this testimony here?

Mr. KALISH. Pardon?

Senator ANDERSON. We are trying to hold these to 15 minutes. Will you stay under that?

Mr. KALISH. Yes; I am not reading from the testimony, statements that I have submitted, because they are too long. I have geared ' presentation for about 12 minutes. You see we have submitted statements on behalf of about five or six different foreign agency banks, including the Puerto Rican bank, so it would be impossible to have them all. I am here to speak about two matters under the proposed Foreign Investors Tax Act of 1966, affecting the foreign agency and branch banks in the United States.

The first issue concerns the taxation of interest on U.S. Government obligations at a flat rate of 30 percent without any deduction for ordinary and necessary business expenses where these securities are held by Puerto Rican branches of Puerto Rican banks rather than by U.S. branches of such banks. If these securities were held by a U.S. branch of these banks there would be little question that these expenses would be deductible.

Under present law a Puerto Rican bank doing business in the United States is taxed on its U.S. source income, even though such U.S. source income may be earned in Puerto Rico. It is taxed at the regular corporate rates after the allowance of all applicable business expenses. Under H.R. 13103 only income which is effectively connected with the conduct of the trade or business in the United States will be taxed at the regular corporate rates after the allowance of all related business expenses.

Interest income from U.S. Government obligations earned by Puerto Rican branches will suffer a tax at 30 percent on the gross amount received without any deduction for ordinary and necessary business expenses. A gross income tax at 30 percent would be confiscatory since a Puerto Rican bank could not earn a profit after deducting all applicable expenses plus the U.S. gross income tax.

This is due to the fact that a Puerto Rican bank must borrow money from depositors in order to obtain the funds to acquire these Government securities. The net income, after deducting the interest costs of borrowed moneys plus investment department's expenses, leaves a profit margin considerably less than 30 percent of the gross amount of interest income received on these U.S. Government obligations.

Therefore, as demonstrated in the statement prepared and filed by Banco Popular de Puerto Rico, substantial losses would have resulted from these investments over the past 5 years if this bank were taxed at 30 percent on the gross interest income received through these investments. Banco Popular would have paid a tax on this income at an effective rate between about 152 and 177 percent. The same situation would also hold true for Banco de Ponce whom we are also representing in this testimony.

Furthermore, Puerto Rican banks will be treated less favorably under H.R. 13103 than most foreign banking institutions earning interest income from U.S. obligations. Many, if not most, foreign banks doing business in the United States are resident in countries having income tax treaties with the United States where the withholding rate is reduced from 30 percent to either 15, 10, 5 percent, or even zero. This fact is fully documented in the statements we have submitted.

Because of these income tax treaties, H.R. 13103 would be treating more favorably a truly foreign corporation rather thon one who is only considered foreign for tax purposes by a fiction of law.

Puerto Rican banks must invest in the U.S. Government obligations because they are part of the U.S. banking community, and are faced with the same problems and conditions as domestic banking institutions. Although they are organized under the laws of Puerto Rico, they are nevertheless subject to certain U.S. banking laws.

For example, all Puerto Rican banks are insured by the Federal Deposit Insurance Corporation, which subjects them to Federal regulation on their financial operations.

Federal regulation requires sound asset liquidity, and investments in U.S. Government obligations are customarily used to provide the required security for Federal deposits. By way of illustration, investments in U.S. Government obligations are necessary for the performance of the following activities: Acting as depositories for the U.S. Government and its Federal agencies, including the collection of Federal withholding taxes in Puerto Rico; 2, selling and redeeming U.S. savings bonds in Puerto Rico; 3, operating facilities at Army, Navy, and Air Force installations, just to name a few.

It is respectfully submitted that the U.S. source investment income of resident Puerto Rican banking corporations be treated as effectively connected with the conduct of their trade or business in the United States, even though such income is earned by a branch outside of the United States such as in Puerto Rico, so as to insure a deduction for all applicable ordinary and necessary business expenses related to earning this income.

The second issue on which I am testifying which concerns all foreign banks including the two mentioned Puerto Rican banks, and, in particular, the Hongkong & Shanghai Banking Corp., Barclay's Bank, and Bank of China, for whom we have also submitted statements on their behalf. The second issue concerns all foreign banks having U.S. branches or agencies and deals with the proposed rule that a U.S. place of business of a foreign bank is to be taxed by the United States on its foreign source dividends, interest, and gains from the sales of securities attributed thereto under the so-called effectively connected concept.

Under present law a foreign bank engaged in trade or business in the United States is taxed only on its income from sources within the United States. It is not taxed on its income derived from sources outside of the United States, regardless as to whether or not such foreign source income is attributed to its U.S. place of business.

Interest received from foreign obligors, including interest on securities issued by foreign governments, is exempt from U.S. income tax inasmuch as it is income derived from sources outside the United States.

Under H.R. 13103 foreign source interest income or dividend income will be subject to U.S. income tax if it is attributable to a U.S. office; that is, a domestic agency or branch of a foreign banking corporation.

The object of this provision is to treat the U.S. branch of a foreign banking corporation the same for tax purposes as the U.S. branch of a domestic bank.

At first appearances it may seem equitable to tax a U.S. branch of a foreign bank on its foreign source dividends, interest, and gains from the sales of securities since a U.S. branch of a domestic bank is also taxed on that same basis. However, closer investigation reveals that domestic banks enjoy certain income tax privileges which are not accorded to foreign banking institutions engaged in trade or business in the United States.

What are these privileges accorded to domestic but not foreign banks? A domestic bank may claim a deduction for an addition to a reserve for bad debts based upon a fixed formula without regard to its actual bad debt experience. The U.S. branch of a foreign bank may only claim a deduction based upon its actual bad debt experience and is not permitted to use the special formula available to domestic banks.

Second, to the extent that losses from the sale of securities exceed the gains therefrom, a domestic bank may claim such excesses as an ordinary deduction applicable against income taxed at 48 percent. A resident foreign bank may only carry such excess loss forward for a period of 5 years to be offset against gains taxed at 25 percent.

To the extent that the resident foreign bank does not have capital gains to offset against such losses the carryovers can be lost forever.

Thirdly, a domestic bank is permitted to deduct interest paid on deposits and other expenses incurred in earning tax exempt interest income from State and municipal securities. A resident foreign bank may only deduct those expenses related to earning taxable income from sources within the United States. This means that any expenses incurred in earning tax-exempt interest income from State and municipal bonds is not deductible by a resident foreign bank.

It is, therefore, submitted that taxing the U.S. office of a foreign bank on its foreign source dividends, interest, and gains from the sales of securities will not achieve the stated purpose of the bill to provide equitable tax treatment for their investments in the United States.

Furthermore, a provision taxing a U.S. branch or agency of a foreign bank on foreign source income attributable thereto is in conflict with practically all of our income tax treaties of the United States which are presently in effect.

A foreign bank organized in a treaty country can only be taxed on its U.S. source income which is attributable to a permanent establishment in the United States.

A foreign bank organized in a nontreaty country would be taxed on United States and foreign source income attributable to its U.S. place of business under H.R. 13103.

Thus, this provision would also provide inequitable U.S. tax treatment even between foreign banks doing business in the United States.

Lastly, it has always been fundamental to American democrat philossophy that the Federal Government's right to tax is based upon the protection of life and property, and that the income to be levied upon is the income which is created by activities and property protected by the Government. The mere fact that a bond or a security or bill of exchange is physically located in the United States or is accounted for by the U.S. branch or agency does not mean that the United States is protecting the property represented by this document.

The foreign resident's country, the obligor upon the bond or bill of exchange, protects the property rights represented by the security, and properly exercises the jurisdiction to tax the foreign bank which holds the obligation. By the same token, the country of organization of the foreign bank, which holds the obligation, may also choose to tax the income because it offers worldwide protection to that foreign bank. It seems it is unconscionable for the United States to attempt to tax such transactions where the securities and negotiable instruments are not governed by the laws of the United States, none of the parties handling the transactions are located in the United States, and all transfers of currency concerning principal and interest take place outside the United States, simply because the physical document, the document may be physically held in the U.S. office of the resident foreign bank may be accounted for through the U.S. office or because the funds may have been advanced by the U.S. office.

In view of the fact that the taxation of a foreign source income attributable to a U.S. place of business does not provide equitable tax treatment between domestic and foreign banking institutions, nor, for that matter, between foreign banks organized in treaty countries and those organized in nontreaty countries, it is difficult to understand why this group of taxpayers should be selected for such discriminatory treatment when the effectively connected concept was restricted severely by the House Ways and Means Committee in its application to foreign source income.

It should be noted that House Report No. 1450 attached to H.R. 13103, which goes into considerable detail to explain the objectives of each of these provisions of the proposed bill, fails to indicate the reason for placing resident foreign banking institutions in this inequitable situation.

It is respectfully submitted that U.S. taxation of foreign source dividends, interest and gains from sales of securities attributable to a U.S. place of business of a foreign bank will not fulfill the stated objectives of H.R. 13103 to provide more equitable tax treatment for their investments in the United States.

If Congress wishes to fulfill this objective, then it should consider either not taxing resident foreign banks on such foreign source in-income or else extend to them the same privileges accorded to domestic banks.

It is respectfully recommended that U.S. offices of foreign banks not be taxed on their foreign source income which might be attributed thereto. Thank you.

Senator ANDERSON. Well, thank you. We know there are some problems with respect to this matter, and the staff is trying to work out an amendment that might be offered on this question of the payment of taxes on bonds, and so forth.

Senator Carlson.

Senator CARLSON. Just one thing, Mr. Kalish. Did you appear before the House Ways and Means Committee when this legislation was under consideration?

Mr. KALISH. No, I did not. As I understand, there was only one hearing as I recall. It was March 7. We were notified the Friday before at 3 o'clock that all requests had to be in by 12 o'clock, and it was impossible to have attended that meeting. Otherwise, I would have tried to have appeared.

Senator CARLSON. I share the chairman's views in regard to this, and that is the reason I wondered whether you had appeared before the committee.

Mr. KALISH. Thank you.

Senator CARLSON. That is all.

Senator ANDERSON. Senator Dirksen.

Senator DIRKSEN. Doesn't your trouble spring essentially from that one clause, "effectively connected"?

Mr. KALISH. Yes, with respect to the foreign source income. There is a provision in the bill which states that, generally, it is only U.S. source income which will be effectively connected with the conduct of the U.S. trade or business except for three exceptions where foreign source income is considered to be effectively connected in a U.S. trade or business. It is that particular clause that we are concerned about on this second issue which would attract foreign source income to U.S. tax.

In the other case, on the U.S. Government obligations, it is also the "effectively connected" concept which creates the problem. Under present law, this income, U.S. source income, earned in Puerto, is taxed in the United States at the regular corporate rates with a deduction for all the related expenses.

It is the "effectively connected" concept that affects that item a little more pointedly than the other issue that we have, but it affects both.

Senator DIRKSEN. The Treasury has worked with that phrase——

Mr. KALISH. Yes.

Senator DIRKSEN. At least, so they said the other day.

Mr. KALISH. Yes.

Senator DIRKSEN. I made a point that I thought in the bill itself there ought to be a more adequate definition so that you do not leave it to a whole range of interpretations and never know quite where you are because different people will interpret that in different ways.

So it there were a clear definition set out in the statute itself, you would know pretty well where you stand?

Mr. KALISH. Right. Except, of course, the "effectively connected" concept is really a subjective concept which is very, very difficult to define to cover all situations, unfortunately. It does not really—if it set an objective standard that would be a lot more helpful, I would say.

Senator DIRKSEN. Well, they discovered exactly that effect by now.

Mr. KALISH. Yes. Thank you.

Senator DIRKSEN. That is all.

Senator ANDERSON. The members of the committee received a statement from the Bank of Puerto Rico. Was your statement largely drawn from this?

Mr. KALISH. Banco Popular de Puerto Rico?

Senator ANDERSON. Yes.

Mr. KALISH. Actually, we submitted—I will speak for myself, I and for Mr. Burke—we submitted three statements to each of the Senators and yourself, Senator Anderson, one on Banco Popular de Puerto Rico; another one on Hongkong & Shanghai Banking Corporation, and another one on Barclay's Bank, which should be coming in if you have not received it already.

Mr. Burke of Burke & Burke has submitted a statement for the Banco de Ponce, and on the Bank of China, and I have stated here basically what our feelings are and our reasons for believing that not only the Puerto Rican banks, but the foreign agency banks, that the bill should be corrected so as to relieve the one on taxation on U.S. Government obligations at a flat 30 percent rate, and the other not to tax foreign source income to the domestic operations of the foreign agency banks as a whole.

Senator ANDERSON. I wanted to know if you desired to have these placed in full in the record?

Mr. KALISH. Oh, yes; I would like each of the statements, if possible, to be inserted.

Senator ANDERSON. I have not seen the Shanghai one.

Mr. KALISH. The Hongkong statement is also there, too. I believe it should have been submitted.

There will be one on Barclay's Bank, which you may not have received yet. We had a little difficulty in typing, and that should be coming down either today or tomorrow, I would say, if it has not arrived yet.

Senator ANDERSON. Thank you very much.

(The documents previously referred to follow:)

STATEMENT OF BANCO DE PONCE, SUBMITTED BY ROBERTO DE JESUS TOBO

Impact of Proposed "Foreign Investors Tax Act of 1966" (H.R. 13103) on Puerto Rican Banking Corporations having Branches in the United States

INTRODUCTION

This memorandum is addressed specifically to the impact on Banco de Ponce of certain provisions of H.R. 13103, the proposed Foreign Investors Tax Act of 1966, (hereinafter sometimes referred to as "the Bill"), as recently passed by the House of Representatives. Banco de Ponce is a Puerto Rican banking corporation having its head office in the City of Ponce and operating branches throughout the island of Puerto Rico and in the continental United States, where it has three branches in the City of New York. Inasmuch, however, as neither the Internal Revenue Code nor the Bill differentiates between corporations incorporated in Puerto Rico and those incorporated in foreign countries, the defects in the Bill here considered and the remedies proposed below are not restricted in their application to this one bank nor to Puerto Rican banks generally, and although, as will be shown below, there are special considerations applicable to Puerto Rican banks which do not apply to others, the following discussion nevertheless illustrates problems of widespread application.

I. EXISTING LAW

1. For income tax purposes, corporations organized under the laws of Puerto Rico are deemed "foreign" and are dealt with in the Internal Revenue Code in the same manner as corporations organized under the laws of any foreign country. See Code Secs. 7701(a)(4), (5) and (9) and 7701(e).

2. Foreign corporations *not* engaged in trade or business within the United States are taxed under and only to the extent provided in Sec. 881 of the Internal Revenue Code, which imposes a tax at a flat rate of 30% on income received from U.S. sources as interest, dividends and other types of "fixed or determinable annual or periodical" income. This tax is in lieu of the tax imposed on domestic corporations under Sec. 11 of the Code. It reaches only these types of income and is based on the gross amount of such income, without the allowance of any deductions or credits.

3. Foreign corporations which *are* engaged in trade or business within the United States, on the other hand, are taxed under Sec. 882 of the Code, which provides that such corporations shall be taxable in the same manner as domestic corporations, i.e., on their *net* income at the rates prescribed by Sec. 11 (current maximum, 48%), with the exception that their gross income includes only gross income from sources within the United States and deductions are allowed, in general, only to the extent that they are connected with such income.

4. Sections 881 and 882 are thus mutually exclusive, a foreign corporation being taxable under one or the other depending solely on whether or not it is engaged in the conduct of a trade or business in the United States, but never under both of these sections at the same time. Banco de Ponce, being deemed a foreign corporation as stated in ¶ 1 and being engaged in business within the United States through its New York City branches, is taxable under Sec. 882.

5. The application of Sec. 882 may be illustrated by the example set forth in the annexed Schedule I, based on figures which, while not actual, closely approximate in essential particulars the magnitude and nature of the Bank's income and

expense for a typical taxable year. On the basis of these figures, the Bank's tax under existing law on $2,000,000 of gross income from U.S. sources would amount to $233,500.

II. EFFECT OF H.R. 13103

1. The new bill makes many changes in the Code provisions dealing with the taxation of non-resident aliens and foreign corporations, but the particular points that concern us here are:

(a) The provisions of Sec. 4 of the Bill amending Code Secs. 881 and 882 so that these two sections would no longer be mutually exclusive, but instead would tax the foreign corporation under either or both of these sections depending on whether its income is or is not "*effectively connected* with the conduct of a trade or business within the United States"; and

(b) The provisions of Sec. 864(c)(4) as added to the Internal Revenue Code by Sec. 2(d) of the Bill which have the effect of including in the definition of the term "income which is effectively connected with the conduct of a trade or business within the United States" certain types of income derived from sources outside the United States.

In other words, under these provisions of Bill, all income *not* deemed effectively connected with the conduct of a trade or business within the United States, to the extent that it is taxable at all, would be taxable under Sec. 881 at the 30% rate on the gross amount received, while all income which is deemed so connected would be taxable under Sec. 882 at regular domestic corporate rates on the net amount received after the allowance of related deductions and this will be so, in the case of the interest income of a bank, even though it is derived from sources outside the United States. Thus, the Bill, while making no change in the case of a bank having no branch or agency here, completely changes the approach in the case of the Bank which does have branches or agencies here, so that unless the interest received can be made to meet the test of being "effectively connected" with the United States operation, it will be taxed on the gross amount of such interest at the 30% rate without any offsets for expenses or losses, as if it had no United States business operations at all, while the rest of its United States operations, including any interest or capital gains income from sources outside the United States that can be deemed "effectively connected" with the United States operations, will be taxed at domestic rates on net income.

2. The effect of these changes in the law are illustrated in the annexed Schedule II, from which it will be seen that on the basis of the same income and expense figures as those used in Schedule I, the Bank's tax computed under the Bill would be $421,300 as compared with $233,500 under existing law, an increase of $187,800 or more than 80%.

III. PROVISIONS OF H.R. 13103 REQUIRING REVISION

1. The severity of the Bill's impact on taxpayers in Banco de Ponce's position as disclosed in the preceding paragraph raises the question of whether this result is consistent with what the Bill is intended to accomplish. Obviously any provision of the Bill which operates in specific factual situations so as to defeat its basic purposes is defective and requires revision. These purposes are indicated in general terms by its title: "A bill to provide equitable tax treatment for foreign investment in the United States," and are clearly described in the Ways and Means Committee Report on the Bill, in which the Committee in discussing the background of the Bill (House Report No. 1450, pp. 5 and 6) points out that the proposed legislation was originally prepared by the Treasury Department and introduced in Congress as H.R. 5916, a bill "designed to increase foreign investment in the United States . . . as part of the President's program to improve the balance of payments." In the course of its consideration of this Bill, the Committee decided to expand the scope of the legislation to include a general overhaul of the taxation of non-resident aliens and foreign corporations, as the result of which H.R. 5916 was ultimately superseded by the present Bill, H.R. 13103, a bill designed, as the Report states (p. 8), "to increase the equity of the tax treatment accorded foreign investment in the United States." It is, however, made clear throughout the Report that the original, more limited objective of encouraging foreign investments in the United States through an amelioration of unduly severe tax burdens is still contemplated by H.R. 13103. For example, in giving the reasons for the provisions of Secs. 2 and 4 of the Bill already referred to (pp. 2 and 3, above), the Committee Report criticizes existing law as deterring foreign businessmen and corporations from investing in the

United States and indicates that these provisions are intended to remedy this situation. (House Report No. 1450, ¶ B-2 on p. 14 and ¶ D-1(b) on p. 27.) The climate of the Bill is thus definitely one of amelioration, of relief from inequities and the removal of discriminatory treatment. It is clearly *not* intended as a revenue measure since it is not expected to increase annual revenues to any significant degree. (Report No. 1450, p. 6.)

2. "The equity of the tax treatment accorded foreign investment in the United States" is obviously *not* increased by provisions which increase the tax burdens imposed on such investment by as much as 80 or 90 per cent. The existing provisions of Code Sec. 881, in imposing a tax at the flat rate of 30% on the gross amount of a foreign taxpayer's income, is already imposing a far heavier tax burden than most domestic taxpayers have to bear. The only grounds on which such a tax on gross income can reasonably be justified are: (a) the purely pragmatic ground that such a tax is readily collectible at the source, reducing to a minimum the administrative difficulties inherent in the collection of taxes from alien taxpayers whose persons and business affairs are physically outside the territorial jurisdiction of the United States and (b) the more equitable argument that the tax is imposed only on such types of income as interest, dividends, rents, royalties and the like, and therefore, in most cases at least, reaches only the income derived from resources not tied up in the current operations of the taxpayer's business, and does not really impose a heavier burden than most domestic taxpayers would have to bear on the same types of income. (See Appendix for a note on the legislative history of Code Secs. 881 and 882.)

The first of these grounds for justifying a 30% gross income tax on foreign taxpayers ceases to have any force, of course, in the case of a taxpayer actively engaged in business in the United States. Such a taxpayer is just as completely subject to the jurisdiction of the United States as a domestic taxpayer insofar as the filing and examination of tax returns, the collection of tax deficiencies and all the other apparatus of income tax administration are concerned.

The validity of the second argument fails with the first, for once it becomes administratively feasible to require complete tax returns, there is no longer any necessity or excuse for treating a foreign taxpayer's income from U.S. sources in a sort of vacuum, without reference to the nature of the taxpayer's over-all business or other income-producing activities. It can then be determined with adequate precision whether and to what extent there are expenses or other deductions which should fairly be attributed to the taxpayer's U.S. income and there ceases to be any reason at all for taxing the foreign taxpayer at any different rates or by any different methods than the domestic taxpayer.

These principals, which lie at the root of the distinction made by the existing provisions of Code Secs. 881 and 882 between the taxation of corporations which do not conduct any trade or business in the United States and those which do, may seem too self-evident to be stated, but the Bill, by dividing the income of a foreign corporation carrying on business in the United States into two classes depending on whether or not such income is deemed effectively connected with the conduct of the U.S. business and taxing the income not so connected under Sec. 881 at 30% of the gross amount, violates these principals and definitely discriminates against the foreign taxpayer engaged in business here as compared with the domestic taxpayer.

Furthermore, when the foreign taxpayer in question is an ordinary commercial bank operating branches in the United States, the effect of the Bill would be absolutely confiscatory, as becomes obvious when one considers the case of Banco de Ponce, a quite typical commercial bank. More than 90% of its entire gross income consists of interest. Its net profit before taxes from all of its operations everywhere averages far less than 30% of its entire gross income. To stay in business it obviously must have some margin of profit left after taxes, which means that on the average the effective rate of tax on all of its interest income can be no more than a small fraction of 30% of the gross amount of the interest received. Why, then, should it invest any of its funds in securities subject to a 30% gross income tax if it can possibly avoid it? To ask the question is to answer it.

3. Put another way, the money which a bank invests does not constitute mere surplus or excess funds that would otherwise lie idle; for the most part it is depositor's money, obtained only at substantial cost in interest paid and banking services performed. If the bank's interest income is taxed in an amount greater than the excess of such income over the cost, in interest and other expense, of the money invested to produce it, the result is confiscation. Domestic banks do not

face this problem because they are taxed only on *net* income. Most foreign banks can avoid the problem (and defeat the original purpose of the Bill) by refraining from investing any funds in the United States other than those directly involved in the operation of their U.S. business. Puerto Rican banks, however, cannot resort to this expedient, because for reasons indicated later in this memorandum, they have no choice but to invest a substantial portion of their Puerto Rican funds in U.S. securities regardless of the tax consequences. For them the discriminatory and confiscatory aspects of the Bill are not only harsh and self-defeating; they are unconscionable as well.

4. We have considered above the effect of singling out the income from U.S. sources *not* "effectively connected" with a U.S. trade or business for taxation at 30% of the gross amount, without allowing any offset or deduction for the expense incurred in earning such income or the results of the taxpayer's U.S. business activities. We have now to consider the effect of the provisions of the Bill dealing with the taxation of income which *is* deemed "effectively connected" with the U.S. trade or business, with particular reference to the provisions of Code Sec. 864(c)(4) as added by the Bill and the resultant taxation under Sec. 882 of income from sources outside the United States.

Presumably the concept underlying these provisions is that two otherwise identical businesses conducted in the United States should bear the same tax burdens even though one of them is operated by a foreign corporation and the other by a domestic corporation; that as the domestically owned business pays a tax based on the entire net income of the business, regardless of the geographical source of its income, so also should the foreign-owned business, and that the income of the foreign corporation effectively connected with its U.S. business should therefore be taxed in the same manner as the income of a domestic corporation, regardless of whether the income is derived from sources inside or outside the United States.

The difficulty is that however reasonable this concept may seem in the abstract, the Bill fails to implement it with any degree of consistency. The resultant mixture of mutually contradictory concepts could not help but give rise to extreme hardship and gross inequity in many cases and so defeat the objectives the Bill was intended to achieve.

(a) In the first place, there is a basic conflict between the concepts underlying Secs. 881 and 882 as revised by the Bill. If the determinative factor in deciding whether income is to be taxed in the United States is not the geographical source of the income but the fact that such income is "effectively connected" with the business conducted within the United States, then it would seem to follow that if such income can be shown to be effectively connected with the conduct of a trade or business *outside* the United States, such income should *not* be taxed in the United States. Yet the Bill, in dealing with interest and the other classes of income covered by Code Sec. 881, not only retains the old concept of the geographical source of the income as the determinative factor but enlarges the scope of the section so as to impose the burdens of a 30% gross income tax on resident foreign corporations which have heretofore been taxed only on their *net* income from U.S. sources even when the income can be readily shown to be effectively connected with the conduct of the taxpayer's trade or business outside the United States.

(b) In the second place, perhaps in an effort to deal with some of the untoward consequences of this conflict, the Bill's proposed Code Sec. 864(c)(4)(A) and (B) limits the extent to which income from outside sources is to be deemed "effectively connected" with a U.S. trade or business (and hence taxable here) to only the three specific classes described in clauses (i), (ii) and (iii) of Sec. 864(c)(4)(B), thereby creating yet another basis for discriminatory tax treatment between otherwise comparable taxpayers. The merits of clauses (i) and (iii) are not germane to this discussion, but clause (ii) relates specifically to interest, dividends and certain capital gains income from sources *outside* the United States that are to be deemed effectively connected with the U.S. trade or business and therefore taxable under Sec. 882. As to these types of income, therefore, the Bill carries water on both shoulders, taxing interest from U.S. sources under Code Sec. 881 as revised if not effectively connected with the U.S. business and taxing interest from non-U.S. sources as well as from U.S. sources under Code Sec. 882 if it is so connected. Furthermore, to make matters worse, it does so only in the case of certain specific types of business, one of which is the banking business.

It is not apparent from the Ways and Means Committee Report why *banks* were singled out along with the very limited group of other taxpayers specified in Sec. 864(c)(4)(B) for the application of the concept that income from sources *outside* the United States should be taxed if connected with income derived from the conduct of a U.S. business. Report No. 1450, p. 65, contains the statement that "in general, income described in Clause (ii) of subparagraph (B) does not include income from . . . securities purchased for investment purposes only . . ." If this is meant to apply in the case, for example, of a U.S. branch of the Puerto Rican bank investing its funds (derived, of course, principally from customers' deposits) in Puerto Rican mortgages or other non-continental U.S. securities, it is simply not true. Without investing its funds profitably in interest-bearing securities it could not perform its essential banking services. There is surely no more justification for singling the banking business out for the taxation of income from non-U.S. sources than there is in the case of any other taxpayer regularly engaged in the sale of goods or services to the public.

(c) In the third place, if the purpose of these provisions is indeed to accord more equitable tax treatment to foreign taxpayers, and if in so doing it is deemed appropriate to equate the tax treatment of the U.S. branches of foreign banks with that of domestic banks to the extent of taxing the foreign-source income attributable to their U.S. business operations, then the Bill should also take into account the privileged tax position enjoyed by the domestic banks as against their foreign competitors in other areas and make some provision to equate the tax treatment of domestic and foreign banks in these respects also, e.g.:

(1) The provisions of Code Sec. 582(c), under which banks (defined by Sec. 581 to include only domestic banks) are allowed to treat losses from the sale of corporate and government bonds as ordinary losses fully deductible against ordinary income (taxable at 48%) rather than as capital losses which may be offset only against capital gains (taxable at 25%);

(2) The similar provisions of Code Sec. 582(a) in dealing with losses due to securities becoming worthless;

(3) The right accorded only to domestic banks to take advantage of the special rules promulgated by the Treasury Department for determining the amounts allowable as deductions for additions to the reserve for bad debts. (Rev. Rul. 65–92, 1965–1 C.B., p. 112);

(4) The right accorded to domestic, but not to foreign, banks of deducting interest expense even though the funds on which such interest is paid are invested in tax-exempt state and municipal bonds (cf. Rev. Rul. 61–222, 1961–2 C.B. p. 58), whereas foreign banks may deduct only expenses attributable to the earning of *taxable* income from sources within the United States. (Cf. Code Sec. 882(c)(2), Treas. Regs. Sec. 1.882–3(b) and 1.873–1(a)(1)).

By including banks in the category of foreign taxpayers to be taxed on income from foreign sources under clause (ii) of Code Sec. 864(c)(4)(B) while making no attempt to change such discriminatory features of existing law as those listed above, the Bill merely compounds existing inequities.

5. Except as international tax conventions may alter the picture, the foregoing considerations apply equally to all corporations deemed "foreign" for tax purposes, whether incorporated in a foreign country or in Puerto Rico. In the case of a banking corporation incorporated in Puerto Rico, however, there are additional and even more cogent reasons why some modification of the provisions of the Bill here under discussion is required.

The constitutional status of Puerto Rico is, of course, historically anomalous. Puerto Rico has never enjoyed the clearly defined and well-understood status of a "territory" such as Alaska and Hawaii were before they achieved statehood. Nevertheless, like them, or like any State, Puerto Rico falls wholly within the monetary system of the United States and its sole currency is United States currency. Its banks, including Banco de Ponce, are members of and regulated by the Federal Deposit Insurance Corporation and are eligible for membership in the Federal Reserve System. As depositories of Federal funds, the Puerto Rican banks as such must maintain the required liquidity and to do so, must invest in U.S. government securities. The employees of such banks, whether employed in the United States or in Puerto Rico, are covered by the Social Security and Unemployment Insurance Laws of the United States and the banks must file reports and pay taxes accordingly. In short, for almost every conceivable purpose other than income taxation, the status of Banco de Ponce as a Puerto Rican bank is identical with that of a bank organized under the laws of the United States.

Obviously, therefore, the original purpose of the Bill—that of improving the balance of payments position of the United States—has no application whatever to Puerto Rican banks, except perhaps in the negative sense of making it attractive to them to invest in Canadian government securities, on which there would be no taxation at the source. The inequitable, discriminatory, and in some cases confiscatory, effects of the Bill as it affects a foreign bank with branches in the United States are doubly unfair and illogical in the case of Puerto Rican banks, which are not really "foreign" in the fiscal sense and have no choice but to invest heavily in U.S. government securities.

IV. SUGGESTED REMEDIES

1. Inasmuch as this memorandum is concerned with the impact of the Bill on foreign banking corporations regularly engaged in business in the United States, and more particularly with Puerto Rican banks having branches in the United States, we shall limit our suggestions to this area. We would like to point out, however, that the adverse effects of some of the provisions of the Bill extend over a much broader field and might well justify a thorough restudy of the basic concept reflected in this very complex and in some respects revolutionary piece of legislation. Our preferred remedy, therefore, would be to make no changes in Code Secs. 881 and 882 insofar as the provisions discussed on pp. 2 and 3 above are concerned. This would entail the deletion from the Bill of all the provisions thereof utilizing the "effectively connected" concept as applied to foreign corporations.

2. If, however, it is felt that the general effect of the Bill is desirable and would be too greatly compromised by following the suggestion made in the preceding paragraph, it nevertheless remains true, as shown above, that it is not the purpose or intention of the Bill to impose substantially heavier tax burdens on the U.S. income of foreign corporations than those imposed on domestic corporations, but rather to alleviate excessive tax burdens on foreign investment in the United States where they exist and generally accord more equitable tax treatment to such foreign taxpayers than heretofore. Yet in the case of foreign banks with offices here the Bill does in fact impose such burdens, and at levels amounting in some cases to confiscation. A simple solution and the one which does perhaps the least violence to the plan of the Bill as a whole, while solving the problem of taxpayers like the foreign banks, is to allow each foreign bank to elect whether or not its investment income from U.S. sources (otherwise taxable under the proposed new language of Code Sec. 881) is to be deemed effectively connected with its U.S. business and therefore taxable under Code Sec. 882. Such an election is already provided by the Bill in the case of certain real property income, and parallel language and similar safeguards against abuse could easily be provided for investment income. For example, there might be added to Sec. 882 as revised by the Bill a new subsection (e) similar to subsection (d) as contained in Sec. 4(b) of H.R. 13103 reading somewhat as follows:

"(e) ELECTION TO TREAT U.S. SOURCE INVESTMENT INCOME AS INCOME CONNECTED WITH UNITED STATES BUSINESS.

"(1) IN GENERAL.—A foreign corporation engaged in the active conduct of a banking business which during the taxable year derives any income from sources within the United States.

"(A) which consists of dividends, interest or gain or loss from the sale or exchange of stock, notes, bonds, and other evidences of indebtedness, and

"(B) which, but for this subsection, would not be treated as income effectively connected with the conduct of a trade or business within the United States,

may elect for such taxable year to treat all such income as income which is effectively connected with the conduct of a trade or business within the United States. In such case, such income shall be taxable as provided in subsection (a)(1) whether or not such corporation is engaged in trade or business within the United States during the taxable year. An election under this paragraph for any taxable year shall remain in effect for all subsequent taxable years, except that it may revoked with the consent of the Secretary or his delagate with respect to any taxable year.

"(2) ELECTION AFTER REVOCATION, INC.—Paragraphs (2) and (3) of Section 871(d) shall apply in respect of elections under this subsection in the same manner and to the same effect as they apply in respect of elections under Section 871(d)."

3. This language would cover *all* foreign banking corporations, thereby not only obviating the grossly discriminatory effect of the Bill on Puerto Rican banks with branches in the United States as compared with domestic banks but also, in

the case of other resident foreign banking corporations, encouraging the investment of surplus funds in U.S. securities. If, however, it is felt that only Puerto Rican banks, because of their anomalous status as insiders in the U.S. monetary and banking structure but outsiders for tax purposes, should receive this relief, then for the words, "foreign corporation . . . business" in the first sentence of subsection (e)(1) as proposed above, there could be substituted the words: "A corporation organized under the banking laws of Puerto Rico."

Such special treatment for Puerto Rico is not without precedent. In fact the effect of such a provision would merely be to place a Puerto Rican bank on a parity in respect of the right to be taxed only on net income from U.S. sources with the individual citizen and resident of Puerto Rico under Section 876 of the Code as presently in effect.

4. It will be noted that all of the suggested language of the new subsection (e) as quoted above beginning with the words "may elect" is taken verbatim from new subsection (d) of Code Sec. 882 as set forth in Sec. 4(b) of H.R. 13103, including this phrase at the end of the second sentence: "whether or not such corporation is engaged in trade or business within the United States during the taxable year." The inclusion of this phrase would have the effect of making the right of election available to a *non-resident* foreign banking corporation, provided, of course, that it filed proper income tax returns and otherwise complied with the requirements of Code Sec. 882(c). This seems desirable to avoid unfair discrimination between Puerto Rican banks which do not operate branches in the continental United States, but which are nevertheless under the same compulsion to invest heavily in U.S. securities, and those which do operate such branches.

5. As already pointed out (pp. 7–10), there is no apparent reason why the Bill should single out banks for the taxation of interest and capital gains income from sources outside the United States and it is respectfully submitted that Clause (ii) of Code Sec. 864(c)(4)(B) as added by Sec. 2(d) of the Bill should be revised by deleting the words: "banking, financing, or similar business", and substituting therefor the words: "financing or similar business, other than banking."

If there is thought to be any ambiguity as to what is meant by the term "banking" in the phrase "other than banking", a definition could be added to Subparagraph (B) of Sec. 864(c)(4). Such a definition might adapt the language of Code Sec. 581 and read somewhat as follows:

"For the purpose of clause (ii) the term "banking" means the business conducted within the United States by a bank or trust company, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which, with respect to the business conducted by it within the United States, is subject by law to supervision and examination by State, Territorial or Federal authority having supervision over banking institutions."

CONCLUSIONS

In conclusion, it is submitted that the changes made by the Bill in the provisions of Code Secs. 881 and 882 discussed above do not "increase the equity of the tax treatment accorded foreign investment in the United States"; that on the contrary, in many cases, and particularly in the case of foreign banking corporations, they impose drastic and unfair new burdens on such investment wholly at variance with the stated purposes of the Bill; that the best solution for the present would be to make no change in existing law insofar as these provisions of Secs. 881 and 882 are concerned; but that if the new concepts imported into the Code by the Bill are felt to represent progress toward more equitable treatment of foreign taxpayers in other areas, then it is urged most strongly that for the reasons set forth in this memorandum, foreign banking corporations carrying on business in the United States, and especially the Puerto Rican banks, should be given the option suggested above of electing whether to be taxed by the old methods or the new and should also be excluded from the special group of taxpayers singled out by Sec. 864(c)(4)(B) for the novel experiment of taxing foreign corporations on income derived from sources outside the United States.

Respectfully submitted.

BANCO DE PONCE.

Dated: July 27, 1966.

SCHEDULE I

Computation of tax under existing law on Puerto Rican banking corporation with U.S. branches

Assume that the gross income of the bank as a whole from all sources is $10 million, consisting of:

(1) Income from sources within the United States:	
(a) Interest on U.S. Government bonds held by head office in Puerto Rico	$1,200,000
(b) Interest on commercial loans by Puerto Rican branches to U.S. residents	50,000
(c) Interest on U.S. Government bonds held by U.S. branches	200,000
(d) Interest on commercial loans by U.S. branches to U.S. residents	500,000
(e) Miscellaneous income of U.S. branches from U.S. sources	50,000
Total income from U.S. sources	2,000,000
(2) Income from sources outside the United States:	
(a) Interest income of head office and Puerto Rican branches from sources outside the United States	6,450,000
(b) Interest income of U.S. branches on FHA guaranteed mortgages and commercial loans to residents of Puerto Rico	600,000
(c) Miscellaneous income of head office and Puerto Rican branches from sources outside the United States	950,000
Total income from non-U.S. sources	8,000,000

Assume expenses allowable as deductions in computing net income from sources within the United States under Code section 882(c) as follows:

Expenses directly attributable to operation of U.S. branches	$700,000
Allocation of general overhead and interest expense of the bank as a whole ($4,000,000) which cannot be attributed to any particular source of income, apportioned in ratio of gross income from each source to total gross income in accordance with Code Sec. 882(c)(2) and Regs. Sec. 1.873-1(a)(1) and 1.882-3(b)(2): $\frac{4,000,000 \times 2,000,000}{10,000,000} =$	800,000
Total allowable deductions	1,500,000

COMPUTATION OF TAX

Gross income from U.S. sources	2,000,000
Deductions attributable thereto	1,500,000
Net taxable income	500,000
Taxable at 22 percent $25,000	5,500
Taxable at 48 percent $475,000	228,000
Total tax	233,500

SCHEDULE II

Computation of tax under H.R. 13103 based on same facts and figures as schedule I

A. Tax on income not effectively connected with U.S. business, section 881:	
(1) Interest on U.S. Government bonds held by head office in Puerto Rico—schedule I, item (1)(a)	$1,200,000
(2) Interest on commercial loans made by Puerto Rican branches to U.S. residents, schedule I, item (1)(b)	50,000
Total income taxable under section 881	1,250,000
Tax at 30 percent	375,000

Computation of tax under H.R. 13103 based on same facts and figures as schedule I—Continued

B. Tax on income effectively connected with U.S. business, section 882:

(1) Gross income:

(*a*) Interest on U.S. Government bonds held by U.S. branches, schedule I, item (1)(c)	200,000
(*b*) Interest on commercial loans made by U.S. branches to U.S. residents, schedule I, item (1)(d)	500,000
(*c*) Interest income of U.S. branches on FHA guaranteed mortgages and commercial loans to residents of Puerto Rico, schedule I, item 2(b)	600,000
(*d*) Miscellaneous income of U.S. branches, schedule I, item (1)(e)	50,000
Total gross income for section 882	1,350,000

(2) Deductions applicable to gross income taxable under section 882:

(*a*) Expenses directly attributable to U.S. branches as in schedule I	700,000
(*b*) Deductions apportioned on basis of figures in schedule II–B per formula as in schedule I: $4{,}000{,}000 \times \frac{1{,}350{,}000}{10{,}000{,}000} =$	540,000
Total allowable deductions	1,240,000

COMPUTATION OF TAX, SECTION 882

Gross income connected with U.S. business	1,350,000
Deductions attributable thereto	1,240,000
Net income taxable under section 882	110,000
Taxable at 22 percent: $25,000	5,500
Taxable at 48 percent: $85,000	40,800
Total tax, section 882	46,300

The total tax liability under H.R. 13103 is the sum of the taxes computed under sections 881 and 882 as follows:

Section 881, as per A, above	$375,000
Section 882, as per B, above	46,300
Total tax liability	421,300

APPENDIX. LEGISLATIVE HISTORY OF INTERNAL REVENUE CODE SECTIONS 881 AND 882

The substance of Sections 881 and 882 of the Internal Revenue Code of 1954 as now in effect was derived from Sections 231(a) and (b) of the Internal Revenue Code of 1939. Section 231 of the 1939 Code, along with the corresponding provisions relating to non-resident alien individuals found in Section 211, first appeared in the income tax law in the Revenue Act of 1936.

In explaining Sections 211 and 231 of the Revenue Act of 1936, which superseded a system under which all foreign taxpayers were taxed on net income and capital gains like domestic taxpayers with reliance placed on the filing of returns instead of withholding at the source, the House Ways and Means Committee had this to say in its Report (74th Congress, 2nd Sess., H. Report No. 2475, pp. 9 and 10).

"In the case of a foreign corporation not engaged in trade or business within the United States and not having an office or place of business therein, it is proposed to levy a flat rate of tax . . . on the grass income of such corporation from interest, dividends . . . and other fixed and determinable income (not including capital gains) . . . to be collected at the source.

"It is believed that the proposed revision of our system of taxing nonresident aliens and foreign corporations will be productive of substantial amounts of additional revenue, since *it replaces a theoretical system impractical of administration in a great number of cases.*" [Italics added.]

The rate of tax imposed by Sec. 231(a) of the Revenue Act of 1936 on the gross amount of interest income was 15%, equal to the maximum tax rate applicable to domestic corporations under that Act. The following table shows the comparable tax rates in each category for all subsequent years:

Years	Flat rate of tax on interest income, nonresident foreign corporations (percent)	Top bracket domestic corporations [1]
1936-40	15	15 percent (19 percent for 1939; 24 percent for 1940).
1941	27½	31 percent.
1942 to date	30	40 percent (through 1945; thereafter varying between 38 percent and 52 percent; now 48 percent.)

[1] Exclusive of excess profits tax.

STATEMENT OF R. CARRION, JR., PRESIDENT, BANCO POPULAR DE PUERTO RICO

INTRODUCTION

Banco Popular de Puerto Rico, a corporation organized under the laws of The Commonwealth of Puerto Rico, is engaged in the commercial banking business. This taxpayer has forty-one branches and its Head Office located in this Commonwealth, in addition to three branches in New York City, which service the local Puerto Rican population with general banking services, including the making of loans, and the maintenance of checking and savings accounts for depositors. All excess available funds of the entire bank are kept at the Head Office in San Juan, Puerto Rico, where they are invested under the direction of the Investment Officer. Currently, the bank has approximately $35,000,000 invested in United States Treasury and other Federal Agency obligations, which yield the bulk of its U.S. Source income.

PRESENT RULES

Under the tax rules presently in effect, the bank is taxable in much the same manner as a domestic corporation since it is engaged in trade or business in the United States. However, under Section 882 of the 1954 Internal Revenue Code as amended, it is only taxable on its gross income from sources within the United States less the applicable deductions. It is not taxable on income derived from sources without the United States. Interest income derived from a foreign government or foreign resident entity is generally excluded from U.S. income tax unless such entity derives 20% or more of its gross income from U.S. sources (Section 861(a)(1)(B)). Interest received from securities of the United States Government is treated as income from sources within the United States under Section 861(a)(1) of the Code regardless of where received, and is combined with the other taxable U.S. source income (including that generated by the New York branches) for Federal income tax purposes. All expenses, losses and other deductions properly apportioned or allocated to the items of taxable gross income and a ratable part of any other expenses, losses and other deductions which cannot definitely be allocated to some item or class of taxable gross income, but which are related thereto, are allowable in computing taxable income (Section 861(b) and 882(c)(2) of the Code; Treasury Regulation Section 1.882-3(b)(2) and 1.873-1(a)(1)). Such expenses, to the extent allowable under the above rules, may be claimed regardless of whether they are incurred by the New York or Puerto Rican offices of the bank. In other words, the bank is taxed as a single entity regardless of whether the U.S. taxable income is earned by the New York branches or by a Puerto Rican office of the bank.

PROSPECTIVE RULES UNDER H.R. 13103

Though, the Foreign Investors Tax Act, according to the Report of the Committee on Ways and Means, House of Representatives, accompanying H.R. 13103, is designed to "stimulate foreign investment in the United States" and provide "equitable tax treatment by the United States of nonresident aliens and foreign corporations," it proposes to change the present tax rules radically and will have a serious and arbitrary effect on this taxpayer. Under the bill in its present form (H.R. 13103), the gross income of a resident foreign corporation would be divided into two categories:

(1) gross income which is effectively connected with the conduct of a trade or business within the United States. (H.R. 13103, Section 4(b)).

(2) gross income which is derived from sources within the United States and which is not effectively connected with the conduct of a trade or business in the United States. (H.R. 13103, Section 4(a)).

The first category of income would be taxed at the regular corporate rates under Section 11 of the Code after an allowance for the appropriate deductions (H.R. 13103, Section 4(b) amending Section 882(a) and (c)), or at the capital gain rate under Section 1201(a) of the Code. In this category foreign source income will be treated as "effectively connected" with the U.S. business if the foreign entity conducts such business through an office or other fixed place of business within the United States, such income is attributable thereto, and it consists of dividends, interest or gains from the sale of stock, securities or notes derived in the conduct of a banking business. (Section 2(d) of the Bill and proposed Section 864(c)(4)(B)(ii) of the Code). The second category of income would be taxed at a flat rate of 30 per cent upon the gross amount received without any deduction for applicable business expenses (H.R. 13103, Section 4(a) amending Section 881(a)), subject to withholding at source (H.R. 13103, Section 4(c) amending Section 1442(a)).

INTEREST INCOME ON U.S. OBLIGATIONS

The bill, as currently drafted, would levey a confiscatory 30 per cent gross income tax on the interest income earned by the Head Office in San Juan from investments in U. S. obligations since such income is not effectively connected with the conduct of the banking business by the New York branches. The funds used to acquire these obligations are generated by the forty-one branches of the bank in Puerto Rico. The decisions as to when and how these funds should be invested are made by the Investment Officer in San Juan; and lastly, the investments and income dervied therefrom are accounted for through the Head Office in Puerto Rico. Nevertheless, considerable expenses are incurred to earn this income. The taxpayer's primary sources of excess available capital are deposits and other borrowings. The bank incurs expenses attributed to these funds, such as interest and business overhead, inasmuch as a banking operation is continuously concerned with the borrowing, lending and investing of funds. A tax on gross income, without a deduction for allocable expenses would result in a tax at an effective rate in excess of 100 per cent of net income. This is clearly indicated from the illustration set forth on Exhibit A-1 and A-2 attached to and made a part of this statement. Based on the investment income earned by the bank and other financial information taken from its Federal and Puerto Rican income tax returns for the past five years, we have computed the U. S. income tax applicable under present law after the allowance of deductible expenses in accordance with Section 882(c)(2). (See also Treas. Reg. Sec. 1.882-3(b)(2) and 1.873-1(a)(1)). We have also computed the U. S. income tax liability assuming that the provisions of Sections 4(a) and 4(b) of H.R. 13103 were in effect for each of these years. The confiscatory nature of H.R. 13103 is quite evident from the fact that in each case the applicable expenses plus the 30 per cent tax on the gross interest income received far exceed the gross amount of interest income from U. S. obligations. The effective rate of Federal income tax on U. S. source interest income ranges from 152% to 177, creating a substantial loss in each case.

It is also submitted that Puerto Rican banks will be treated less favorably than most foreign banking institutions earning interest income from U.S. obligations. In the absence of a tax treaty provision, Section 4(a) of H.R. 13103 imposes a flat 30 per cent tax on such income of a foreign banking institution earned by an office outside the United States. Many, if not most, of the foreign banks earning income from sources within the United States are resident in

67-485—66——13

countries with whom the United States has an income tax treaty containing a provision reducing the rate of withholding to 15 per cent or less. For example, Article VII of the United Kingdom Income Tax Treaty exempts interest from any withholding tax, as do many of the income tax conventions concluded by the United States with other foreign countries. Article VI of the Japanese Income Tax Treaty imposes a tax of only 10 per cent on interest income derived from sources within the United States, and Article VII of the Swiss Treaty reduces such withholding rate to 5 per cent. The French and Belgium Income Tax Treaties impose a 15 per cent tax on U.S. source interest income as provided in Article 6A and Article VIII A respectively. Even though a foreign banking institution may be engaged in trade or business in the United States through a permanent establishment, if the interest income is not effectively connected with the conduct of a trade or business within the United States, then the reduced rate of tax or exemption from tax under the treaty, applicable where there is no permanent establishment, shall be applicable in such case. (Section 5(a) of H.R. 13103 amending Section 894 of the Code). This means that a foreign banking institution resident in a treaty country would only be subject to a maximum withholding tax of 15 per cent, and frequently exempt, in lieu of the 30 per cent rate applicable to Puerto Rican banks. Because of these treaty provisions, the United States is inadvertently treating more favorably a truly foreign corporation rather than one who is only considered foreign for tax purposes by a fiction of law. Politically a Puerto Rican bank is a U.S. entity and one against which the U.S. has not discriminated but has generally sought to help as other U.S. banks. Therefore, it would seem that Puerto Rican banking institutions should not be treated less favorably than banking institutions located in foreign countries.

Because of the close political and economic ties with the United States, Puerto Rican banking institutions are faced with the same problems and conditions as domestic U.S. banking institutions. Although they are organized under the laws of Puerto Rico, they are, nevertheless, subject to certain U.S. banking laws. For example, all banks in Puerto Rico are insured by the Federal Deposit Insuranc Corporation. This means that the taxpayer's overall operation is subject to Federal regulation. Such regulation requires sound asset liquidity, and, specifically, investments in U.S. obligations to provide the required security for Federal deposits (6 U.S.C. § 15). Moreover, Puerto Rican banks are approved depositories for the U.S. Government, and a good many of the Federal Agencies carry accounts in Puerto Rican banks, such as the well-known Tax and Loan Account of the U.S. Treasury. Puerto Rican banks also sell and redeem U.S. Savings Bonds, and operate branches and facilities at various Army, Navy, and Air Force installations in Puerto Rico. As a result of these activities, and also following generally accepted and required banking principles, Puerto Rican banks carry a secondary reserve for their total deposits in Puerto Rico, consisting chiefly of bonds and notes of the U.S. Government and its agencies. Thus, the penalty it must pay for complying with U.S. bank rules and sound American banking practice as to asset liquidity, is a tax penalty which is confiscatory and unrelated to the realities of the banking business. If interest income from U.S. obligations were earned by one of the New York branches of the bank, there would be no question that the cost of borrowing the funds to purchase these obligations would be deductible as well as other investment overhead expenses. The mere fact that interest income from U.S. Government securities is earned by a Puerto Rican operating branch rather than a U.S. branch of the bank does not provide a sufficient basis in logic and reason for distrinction. In either case, the taxpayer is operating a banking business requiring the incurrence of the above expenses to earn such income, regardless of whether or not such taxable U.S. source of income is effectively connected with the conduct of the trade or business by the New York branches.

There are a number of ways in which H.R. 13103 can be amended so as to avoid this problem and, in addition, further the objectives of this legislation. Several of them are outlined below and are submitted for your consideration:

1. Permit a resident foreign banking corporation, or a Puerto Rican banking corporation in particular, to elect to treat U.S. source investment income, or income from U.S. obligations, as effectively connected with the conduct of the trade or business in the United States. By so doing, a deduction could be claimed for these expenses which are connected with earning such income, and an allocable share of those expenses which are attributable to earning such

income but the amount of which cannot be specifically identified, regardless of where these expenses are incurred.

A provision could be inserted in Section 882 similar to subsection (d) "Election to Treat Real Property Income as Income Connected with United States Business.—" as set forth in Section 4(b) of H.R. 13103, and might read as follows:

"(e) ELECTION TO TREAT U.S. SOURCE INVESTMENT INCOME AS INCOME CONNECTED WITH UNITED STATES BUSINESS.—

"(1) IN GENERAL.—A corporation organized under the banking laws of Puerto Rico (or a foreign country) which during the taxable year derives any income—

"(A) from investment in bonds, notes or other securities issued by the United States, any territory, any political subdivision or agency of the United States or of a territory, or the District of Columbia, and any obligations guaranteed as to interest and principal by any of them, and

"(B) which, but for this subsection, would not be treated as income effectively connected with the conduct of a trade or business within the United States, may elect for such taxable year to treat all such income as income which is effectively connected with the conduct of a trade or business within the United States. In such case, such income shall be taxable as provided in subsection (a)(1) whether or not such corporation is engaged in trade or business within the United States during the taxable year. An election under this paragraph for any taxable year shall remain in effect for all subsequent taxable years, except that it may be revoked with the consent of the Secretary or his delegate with respect to any taxable year.

"(2) ELECTION AFTER REVOCATION, ETC.—Paragraphs (2) and (3) of section 871(d) shall apply in respect of elections under this subsection in the same manner and to the same extent as they apply in respect of elections under section 871(d)."

The above provision, as in the case of income from real property, would treat this U.S. source interest income as effectively connected with the conduct of a trade or business within the United States and taxed at the regular corporate rates as provided in Section 11 of the Internal Revenue Code together with the income of the bank which is effectively connected with the conduct of its banking business in the United States. Such special treatment for Puerto Rico would not be unique under U.S. concepts of taxation. By way of analogy, Section 876 of the Code provides that Section 871 through 875 (dealing with the taxation of U.S. source income of non-resident alien individual) does not apply to a citizen and bona fide resident of Puerto Rico for an entire taxable year. This means that a Puerto Rican individual coming within this section may claim all ordinary and necessary business expenses incurred in connection with earning taxable income, including U.S. source income, even though such expenses are incurred in Puerto Rico. Inasmuch as the proposed Bill would treat taxable interest income not effectively connected with the conduct of the U.S. trade or business as being earned by a non-resident foreign corporation, and since Section 876 recognizes the deductibility of related expenses by Puerto Rican resident individuals not available to non-resident foreigners, this principle should be extended to Puerto Rican banking corporations as recommended above.

2. Exempt resident foreign banking corporations, or Puerto Rican banks in particular, from Federal income tax on U.S. source investment income. Such action would not set a novel precedent for granting Puerto Rican persons a special status under the Internal Revenue Code. Section 931 of the Code already grants a special tax status to U.S. corporations operating in Puerto Rico, exempting them from U.S. income tax if they meet certain statutory requirements. Furthermore, although Puerto Rican corporations are treated as foreign corporations, for purposes of the controlled foreign corporation provisions of the 1962 Revenue Act, Section 957(c) of the Code provides an exclusion from this status for most Puerto Rican corporations, again recognizing the unique position of such entities with respect to the United States and to Federal taxation. Thus, the above exceptions recognize that Puerto Rico has a special position with respect to the United States and is not to be considered in the same light as a foreign country despite the fact that it administers its own tax laws.

3. The second alternative suggestion could be restricted exclusively to interest from obligations of the United States Government or its agencies.

Puerto Rico is a Commonwealth by act of Congress and is subject to Federal legislation that applies to all the States of the Union. The relations between Puerto Rico and the United States are completely different and unique when compared to those of a foreign country with the United States. Puerto Rico is part of the United States, using the same currency, same postal service, under the same customs regulations, etc. The economic ties between the United States mainland and Puerto Rico are closely interrelated by all the Federal agencies which have jurisdiction in Puerto Rico, such as the Armed Forces, the Federal Bureau of Investigation, the Federal Housing Administration, the Department of Agriculture, the Department of Commerce, the Federal Aviation Agency, the Department of the Interior, the Department of Labor, the Treasury Department, and many others. In Puerto Rico there is even a Federal District Court, and its decisions, as well as those of the Commonwealth Courts, can be appealed to the Court of Appeals (First Circuit) and then to the United States Supreme Court. Puerto Ricans are United States citizens and have all the rights, privileges, and duties of a U.S. mainland citizen.

It is, therefore, submitted that the position of Puerto Rican banks, such as this taxpayer, is unique and different from foreign investors. Substantial investments in United States Government obligations (currently $35,000,000) are necessitated because of the relationship of this Commonwealth to the United States in conducting its banking business as outlined above. To subject the gross income derived therefrom to a confiscatory gross income tax of 30 per cent is not only contrary to a major purpose of this Bill to encourage foreign investment in the United States, but also reflects an apparently unintended discrimination against Puerto Rican banks in relationship to mainland banking institutions. This Bill also defeats to some extent the fundamental objective of Congress in providing this Commonwealth with its separate taxation autonomy by subjecting interest income to a Federal tax on the gross amount.

TAXATION OF FOREIGN SOURCE INCOME EFFECTIVELY CONNECTED WITH THE CONDUCT OF A U.S. BANKING BUSINESS

A second provision of the Foreign Investors Tax Act for which the bank seeks amendment is Section 864(c)(4)(B)(ii). This subsection added by Section 2(d) of the Bill provides, in effect, that foreign source income will be treated as "effectively connected" with the U.S. business if the foreign entity conducts such business through an office or other fixed place of business within the United States, such income is attributable thereto, and it consists of dividends, interest or gains from the sale of stock, securities or notes derived in the conduct of a banking business.

The object of the Bill is "to provide more equitable tax treatment for foreign investment in the United States" as stated on page 1 of Report No. 1450 of the Committee on Ways and Means of the House of Representatives to accompany H.R. 13103. We submit that the taxation of foreign source interest income earned by a foreign corporation engaged in the banking business is in derogation of this purpose of the Bill as set forth below:

1. At first appearances, it may seem equitable to tax foreign banking institutions on their foreign source interest income if such income is attributable to activities of an office or place of business in the United States since a domestic bank is taxed on its world-wide income including that derived from sources outside of the United States. However, upon closer analysis, it becomes apparent that domestic banking institutions have certain Federal income tax privileges which are denied resident foreign banks. For example, a domestic bank may claim annual deductions for additions to its reserve for bad debts until the reserve equals 2.4 per cent of loans outstanding at the close of the taxable year, regardless of whether its bad debt experience indicates that any losses, in fact, did result. (Rev. Rul. 65-92, 1965-1 C.B. 112).

A resident foreign bank, on the other hand, may only claim a deduction for those bad debts actually incured, or a deduction for an addition to a reserve for bad debts based upon a reasonable expectation that a percentage of loans will default under the normal rules set forth in Section 166. If, based on subsequent experience, such bad debts do not materialize, the addition to the reserve must be restored to income by the resident foreign bank. Since the primary source of earning income for any bank is the loaning of funds, a resident foreign bank is at a distinct disadvantage in comparison to a domestic banking institution.

2. However, the inequitable tax treatment between domestic and foreign banks goes much further. As a general rule, where a taxpayer corporation disposes of a capital asset at a gain, such gain is taxed at the reduced rate of 25 per cent. Any losses derived from the sale or exchange of capital assets are first offset against the gains from such sales and any excess may be carried forward for a period of five years and utilized against future gains from the sale of capital assets (Section 1212(a)). Any excess of losses over gains from the sale or exchange of capital assets may not be offset against so-called ordinary income taxed at the regular corporate tax rates. In the case of a domestic bank, however, if the losses of the taxable year from sales or exchanges of bonds, debentures, notes, or certificates, or other evidences of indebtedness, issued by any corporation (including one issued by a government or political subdivision thereof), exceed the gains of the taxable year from such sales or exchanges, no such sale or exchange shall be considered a sale or exchange of a capital asset. (Section 582(c), Treas. Reg. Sec. 1.582-1(c)). This means that if the losses exceed the gains from the sale or exchange of such capital assets, a domestic bank secures the benefit of an ordinary deduction applicable against income taxed at the 48 per cent rate. A resident foreign bank may only deduct capital losses against capital gains taxed at the 25 per cent rate and any excess may only be carried forward for five years and charged against capital gains. If it does not have capital gains within such period or not sufficient gains to absorb such losses, the carryover can be lost forever. No deduction for capital losses is permitted against ordinary income.

3. A further area of inequitable treatment stems from the fact that domestic banks are allowed to deduct interest paid on deposits and other expenses incurred in earning tax-exempt interest. Interest income earned on obligations issued by any of the fifty states or their municipalities is exempt from U.S. income tax (Section 103). Section 265(2) sets forth the general rule that no deduction shall be allowed for interest on indebtedness incurred or continued to purchase or carry obligations, the interest from which is wholly exempt from Federal income tax. However, this rule does not apply to domestic banks. The provisions of Section 265(2) have no application to interest paid on indebtedness represented by deposits in banks engaged in the general banking business since such indebtedness is not considered to be "indebtedness incurred or continued to purchase or carry obligations . . ." within the meaning of Section 265. (Rev. Rul. 61-222, 1961-2 C.B. 58). Even though a domestic bank may use a portion of its deposits to purchase tax-exempt state or municipal bonds, the interest expense paid on such deposits is fully deductible without any allocation to the tax-exempt interest income. A resident foreign bank, on the other hand, is not accorded this same privilege. It may only claim a deduction for those expenses which are connected with earning taxable gross income from sources within the United States. (Section 882(c)(2), Treas. Reg. Sec. 1.882-3(b) and 1.873-1(a)(1)). Section 861(a) which defines income from sources within the United States limits this concept to "items of gross income." Municipal and state bond interest is not included in "gross income" (Section 103). Thus, to the extent that comparable interest expense on deposits and other expenses are attributable to tax-exempt bond interest income, they are not deductible by a resident foreign banking corporation, although a domestic banking institution can claim such deductions.

In the light of the foregoing we submit that to tax resident foreign banking corporations on their foreign source dividends, interest, and gains from the sale of securities does not achieve equitable tax treatment for their investments in the United States but serves to aggravate an inequity which exists under present law and would continue under the proposed legislation.

In addition, this novel concept of taxing foreign enterprises on their foreign source income is directly contrary to three-quarters of the Income Tax Treaties concluded by the United States with foreign countries which specifically limit U.S. taxation of foreign enterprises to their U.S. source income. (e.g., Australia—

Article III, Italy—Article III). The U.S. Treasury Department Regulations applicable to those few tax treaties whose provisions allow Federal taxation on all income allocable to a U.S. "permanent establishment", limit this rule to income from sources within the United States, thus evidencing the intent of even these treaties not to tax foreign source income. (e.g., Canada—Regulation Section 519.104, France—Regulation Section 514.105). Since Section 10 of the Bill provides that no amendment made by H.R. 13103 shall apply in any case where its application would be contrary to any treaty obligation of the United States, this motive to tax foreign source income would not apply to those countries with whom the United States has an income tax treaty, thus discriminating severely against those nations with whom the United States has not yet concluded a treaty. Since the United States has not concluded an income tax treaty with Puerto Rico, investments in Puerto Rican or other foreign obligations would be seriously affected under the proposed Bill in a manner not contemplated at the time these tax treaties were negotiated.

In conclusion, it is submitted that the Foreign Investors Tax Act will further aggravate the present discrimination against Puerto Rican and other resident foreign banking institutions instead of providing more equitable tax treatment for their investments in the United States. If Congress wishes to fulfill its stated objective, then it should choose between either not taxing resident foreign banks on their foreign source dividends, interest and gains from the sale of securities or else extend to them the same tax privileges accorded to domestic banks.

It is recommended that this inequity be corrected by excluding resident foreign banks from Section 864(c)(4)(B)(ii) added to the Internal Revenue Code by Section 2(d)(2) of H.R. 13103. This may be accomplished statutorily by deleting the word "Banking" from the phrase. ". . . and either is derived in the active conduct of a (banking), financing, or similar business . . ." set forth in Section 864(c)(4)(B)(ii).

CONCLUSION

Accordingly, it is respectfully requested that H.R. 13103 be amended to provide relief covering the taxation of U.S. interest income earned in Puerto Rico and foreign source interest income effectively connected with the conduct of a U.S. banking business by Puerto Rican banking institutions. It is also respectfully requested that, at such time as the Senate Finance Committee may hold a public hearing on the Foreign Investors Tax Act, the Banco Popular de Puerto Rico be given an opportunity to orally express its views through its representative, Richard H. Kalish, Partner in the firm of Peat, Marwick, Mitchell & Co. (Certified Public Accountants).

R. CARRION, JR.,
President, Banco Popular de Puerto Rico.

EXHIBIT A–1

Effect of the Foreign Investors Tax Act

	1961	1962	1963
Present law:			
Interest, U.S. Government obligations	$827,715.54	$1,307,024.27	$1,855,879.96
Less: Allocable share of expenses on gross to gross ratio	687,559.89	1,048,591.19	1,511,361.59
Net income	140,155.65	258,433.08	344,518.37
Less tax thereon [1]	72,880.94	134,385.20	179,150.27
Income after taxes	67,274.71	124,047.88	165,368.10
Foreign Investors Tax Act:			
Interest, U.S. Government obligations	827,715.54	1,307,024.27	1,855,879.96
Less: 30 percent tax	248,314.66	392,107.28	556,763.99
Income	579,400.88	914,916.99	1,299,115.97
Less: Expenses	687,559.89	1,048,591.19	1,511,361.59
Net income (loss)	(108,159.01)	(133,674.20)	(212,245.62)
Effective tax rate (percent)	177	152	162

[1] Assuming other income exceeds $25,000 used 52 percent rate.

EXHIBIT A-2

Effect of the Foreign Investors Tax Act

	1964	1965
Present law:		
Interest, U.S. Government obligations	$1,756,823.80	$1,589,261.14
Less allocable share of expenses on gross to gross ratio	1,423,818.11	1,299,823.60
Net income	333,005.69	289,437.54
Less tax thereon [1]	166,502.85	138,930.02
Income after taxes	166,502.84	150,507.52
Foreign Investors Tax Act:		
Interest, U.S. Government obligations	1,756,823.80	1,589,261.14
Less 30 percent tax	527,047.14	476,778.34
Income	1,229,776.66	1,112,482.80
Less expenses	1,423,818.11	1,299,823.60
Net income (loss)	(194,041.45)	(187,340.80)
Effective tax rate	158	165

[1] Assuming other income exceeds $25,000 1964, 50-percent rate; 1965, 48-percent rate.

STATEMENT SUBMITTED IN BEHALF OF THE BANK OF CHINA AS TO EFFECT OF THE FOREIGN INVESTORS TAX ACT OF 1966 (H.R. 13103) ON FOREIGN BANKS HAVING AGENCIES IN THE UNITED STATES

This statement is submitted on behalf of Bank of China, a banking corporation organized in 1912 under the laws of the Republic of China with its head office in Taipei, Taiwan, and agencies in many of the major cities of the world, including two in the City of New York, one at No. 40 Wall Street and the other at No. 225 Park Row. The bank is duly authorized under the New York State Banking Law to do business in this State through these two agencies and is, of course, subject to the supervision to the New York State Superintendent of Banks.

Under the existing provisions of the Internal Revenue Code the Bank has the status of a foreign corporation engaged in the conduct of trade or business within the United States and is therefore taxed under Sec. 882 of the Code at the ordinary rates applicable to domestic corporations on all of its net income from sources within the United States including both the income of the New York agencies and the income derived from investments by Head Office in the U.S. government and corporate securities. The Bank's taxable net income for U.S. tax purposes is arrived at by deducting from the total amount of all its gross income from U.S. sources, both Agency and Head Office, all of the allowable deductions related thereto. Such deductions consist of the direct expenses of the New York Agencies and an allocation of Head Office general overhead expense prorated under Code Sec. 882(c)(2) and Treasury Regs., Secs. 1.873-1(a)(1) and 1.882-3(b)(2).

The Bank's New York Agencies also derive income from sources outside the United States, including interest on Canadian government bonds, discount of bills drawn on foreign banks, interest on loans to foreign banks and firms, and other foreign sources, mostly in Japan. This foreign-source income is not taxable under the present provisions of the Code, however, and the expenses related thereto (including both direct New York agency expenses and the allocation of Head Office overhead expenses) are not deductible.

If H.R. 13103 should be enacted in its present form, this would be drastically altered as follows:

1. Under Code Sec. 882 as amended by Section 4 of the Bill, all income from interest and dividends received from U.S. sources held in the Head Office portfolio, together with the related deductions, would be excluded from the computation of the tax based on net income as income not "effectively connected with the conduct of a trade or business within the United States."

2. Under Code Sec. 881 as amended by Sec. 4 of the Bill the income excluded from tax under Sec. 882 as income from U.S. sources not effectively connected with the U.S. business of the Bank, would become taxable at a rate of 30% on the gross amount thereof, without any offsetting deductions or credits

whatever. (There is no income tax treaty between the United States and the National Government of the Republic of China.

3. In addition, by virtue of the provisions of Sec. 864(c)(4)(B) of the Code as added by Sec. 2(d) of the Bill, there would be included in the gross income of the New York agencies all of the income of the agencies derived from sources outside the United States, such as the Canadian and Japanese interest items referred to above, because this income would be deemed effectively connected with the U.S. business of the Bank. (Of course at the same time the related deductions, now disallowed, would become allowable so that only the *net* income from these sources would be taxed at normal domestic corporate rates.)

4. New Code Sec. 906 as added by Sec. 6(a) of the Bill allows foreign corporations to credit against their U.S. tax the foreign income taxes paid on the foreign-source income referred to in ¶ 3 above, subject to the limitations of the existing foreign tax credit provisions of the Code. According to subsec. (b)(1) of the new Code Sec. 906, this credit will not be allowed, however, with respect to any tax imposed by the country of the corporation's domicile unless the income is derived from sources in that country. This means, in the case of the foreign source income of the U.S. agencies of the Bank of China, that no credit would be allowed for any Chinese taxes and that to the extent that income from sources in other countries are subject to lower rates of tax than those paid in the United States, or to no tax at all, the Bank will pay the full U.S. tax on such income as in the case of income from sources within the United States.

By making the question of whether income is or is not "effectively connected with the conduct of a trade or business within the United States" the decisive factor in determining whether the income of a foreign corporation is to be taxed on its net income under Sec. 882 on its gross income under Sec. 881, and by including foreign source income in the measure of the tax under Sec. 882, the Bill reflects a fundamental change in the basic concepts heretofore applicable to the taxation of foreign corporations.

According to its title the purpose of the Bill is "to provide equitable tax treatment for foreign investment in the United States" or, as stated in the report of the House Ways and Means Committee on the Bill (2d Session, 89th Congress, House Report No. 1450, p. 8,) "to increase the equity of the tax treatment accorded foreign investment in the United States."

Whether or not these new concepts are reasonably calculated to achieve these stated purposes of the Bill if consistently carried out and implemented in the Code in the majority of cases, it clearly appears that in the case of foreign banks with agencies or branches in the United States there is no apparent equity in changes which result in drastic increases in a foreign bank's tax liabilities in the United States and it is submitted that as the Bill is drawn, it fails to recognize certain obvious facts generally applicable in the case of ordinary banks and furthermore contains provisions which, in certain cases at least, result in more discriminatory treatment rather than less for the foreign banks and therefore lessens rather than increases the equity of the tax treatment accorded foreign investment in the United States.

In the first place, interest constitutes by far the more important source of income of such a bank and the funds invested by such a bank to produce such income consist mainly of borrowed funds, including customers' deposits and other obligations. Substantial expenses are necessarily incurred by the bank in obtaining the funds invested to produce its interest income. If these expenses are not taken into account in determining the measure of the tax and if the rate of tax is higher than the bank's margin of profit, the result is simply confiscatory. Such a system of taxation, far from encouraging foreign investment in the United States, will effectively prohibit it in the case of more foreign banks, but this is the inevitable effect of taxing interest income from normal banking operations at 30% of the gross amount thereof.

In the second place, the inclusion of income from sources outside the United States in determining the tax of the local agency of the foreign bank represents a radical departure from any previous concepts embodied in our income tax law. Whatever logic this concept might have if applied generally, it has been restricted in its application under this Bill so as to apply only to the extremely limited groups of taxpayers referred to in new Code Sec. 864(c)(4)(B)(i), (ii) and (iii) and to no other class of taxpayers. The banking business is included in clause (ii). By singling out banks, having agencies or branches in the United States for this treatment when other foreign corporations are not so treated appears to be purely discriminatory, and the inequity of this treatment is more evident when it is considered that there are a number of other provisions of the existing Internal Revenue Code which already discriminate to a substantial extent against such banks, e.g.: the provisions of Sec. 582(c) of the Code under which domestic banks are allowed to treat losses on the sale of bonds and other government and corporate obligations as ordinary losses fully deductible from ordinary income while foreign banks having agencies or branches in the United States are not; the similar provisions of Code Sec. 582(a) dealing with losses due to worthless securities; the disallowance of the right to deduct additions to a reserve for bad debts under Rev. Rul. 65–92 1965–1, C.B., 112, and the right to deduct interest and other expense notwithstanding the investment of the bank's funds in tax exempt state and municipal bonds whereas under Sec. 882(c)(2) of the Code and the applicable regulations, foreign banks may deduct only expenses attributable to the earning of *taxable* income from sources within the United States.

It is therefore respectfully submitted that in furtherance of the stated purposes of the Bill and to avoid its present harsh and discriminatory operation in the case of the foreign banks with branches or agencies in the United States, the Bill should be changed so as to permit such banks to treat all interest and dividend income derived from sources within the United States as effectively connected with its U.S. trade or business and to eliminate banks from the operation of the provisions of Sec. 864(c)(4)(b)(ii). These changes can readily be accomplished in various ways. For example, Sec. 864(c) of the Code, as added by Sec. 2(d) of the Bill might be revised (1) by adding at the end of Code Sec. 864(c)(2) the following sentence:

"This paragraph shall not apply to any income derived from sources within the United States in the active conduct of a banking business by a foreign corporation having one or more branches or agencies in the United States which are subject by law to supervision and examination by State, Territorial or Federal authority having supervision over banking institutions."

and (2) by deleting the word "banking" from Clause (ii) of Code Sec. 864(c)(4)(B).

As an alternative to the foregoing proposed revision of Sec. 864(c)(2), the same result might be accomplished by adding to Sec. 882 as amended by the Will a new subsection (e) allowing to foreign banks having branches or agencies in the United States the same option to elect to have *all* their income of the types specified in Sec. 864(c)(2) treated as effectively connected with the conduct of their U.S. business as that granted in the case of real estate income under subsection (d) of Sec. 882 as added by the Bill.

STATEMENT OF ROBERT BEAUMONT, AGENT-IN-CHARGE, THE HONGKONG AND SHANGHAI BANKING CORPORATION

The Hongkong and Shanghai Banking Corporation, organized under the laws of Hong Kong, is engaged in the commercial banking business. In addition to its Head Office located in Hong Kong, and branches in the Far East, it maintains an agency located at 80 Pine Street, New York City which is licensed to do business in New York State, and one at 180 Sansome Street, San Francisco which is licensed to do business in California. The vast majority of stock in the corporation is owned by foreign nationals, and under chapter 70 of the laws of Hong Kong no single shareholder can own more than approximately 3% of the issued and outstanding capital stock. Its banking business in the U.S.A. consists of servicing export and import operations, providing the necessary financing thereof, and offering many of the general banking services of a domestic bank.

Under the tax rules presently in effect, the bank is taxable in much the same manner as a domestic corporation since it is engaged in trade or business in the United States. However, under Section 882 of the 1954 Internal Revenue Code as amended, it is only taxable on its gross income from sources within the United States, less the applicable deductions. Interest received from securities issued by foreign governments is treated as income from sources without the United States under Section 861(a)(1) and 862(a)(1) of the Code regardless of whether or not such interest is received by the New York Agency or a foreign office of the bank. Thus, for example, if this banking corporation purchases bonds issued by the Government of Australia, the interest earned thereon is not taxed by the United States.

The Foreign Investors Tax Act (H.R. 13103) will depart radically from the foregoing principle inasmuch as it will tax certain income from sources without the United States if it is "effectively connected" with the conduct of a trade or business within the United States. Foreign source income will be treated as "effectively connected" with the U.S. business if the foreign entity conducts such business through an office or other fixed place of business within the United States, such income is attributable thereto, and it consists of dividends, interest or gains from the sale of stock, securities or notes derived in the conduct of a banking business. (Section 2(d) of the Bill and proposed Section 864(c)(4)(B)(ii) of the Code).

At present, the Honkong and Shanghai Banking Corporation maintains its investment portfolio of Australian, New Zealand and Union of South Africa government bonds in New York. Since the interest is derived from sources outside the United States it is not presently taxed in the United States. These bonds are retained in New York and may be included as New York assets in setting credit limitations by the New York State banking authorities. Although the proposed legislation and Committee Report (No. 1450) are not entirely clear, it would appear that since these bonds are recorded on the books of the New York Agency in a memorandum account for control purposes only, and since they are considered to be qualifying assets by the New York State banking authorities, they might be attributable to the New York Agency. As a result, under the above stated rule, the interest derived therefrom might be treated as taxable income which is "effectively connected" with the conduct of a trade or business within the United States under the proposed amendments to Section 882 (Section 4(b) of the Bill).

In addition to foreign source interest income derived from Commonwealth investments, which is of great concern to us at the present time, the New York Agency also earns from its commercial banking function other types of interest income from foreign borrowers which, in fact, constitute the greater part of its earnings. It will be appreciated that the Agency is not permitted under New York State law to take deposits from U.S. residents, and consequently it operates entirely on foreign source funds lodged by overseas branches and by customers of those branches. Since the derivation of these funds is foreign and the banks sphere of operations is in the Far East and Middle East it follows that a large percentage of loans and other forms of advances are made by the New York Agency to foreigners. This interest, which is foreign source interest on these loans and advances, would include:

(1) Interest on dollar bills purchased, drawn on a foreigner abroad (no letter of credit involved)—this might be a bill for collection which the New York Agency purchases from the U.S. exporter. The New York Agency will advance the full face amount of the bill to the U.S. exporter and instruct the foreign branch to collect the interest from the foreign importer and remit the proceeds plus interest to the New York Agency.

(2) Interest earned by the New York Agency on overdrafts or loans made to foreigners abroad.

(3) Interest on loans to a foreign borrower in which the New York Agency participates with another bank.

(4) Interest earned by the New York Agency where it participates with the World Bank on loans in countries in which The Hongkong and Shanghai Banking Corporation has branches, such as loans for construction of dams, electrical plants, etc.

The seriousness of the impact of the proposed legislation is apparent for there is little doubt that such income would be considered to be "effectively connected" with the conduct of the U.S. banking business where: (1) the funds loaned are those of the U.S. place of business, or (2) the New York Agency or branch participates in effectuating the transaction between the exporter and importer (e.g., handles the correspondence, transmits documents, inspects documents, opens and advises letters of credit, makes payments, etc.). Furthermore, the fact that the foreign source interest income is accounted for through the New York branch or agency will be given considerable weight in determining whether the income is "effectively connected" with the conduct of a U.S. trade or business. (Section 864(c)(2) and (4)(B)).

The object of the Bill is "to provide more equitable tax treatment for foreign investment in the United States" as stated on page 1 of Report No. 1450 of the Committee on Ways and Means of the House of Representatives to accompany H.R. 13103. We submit that the taxation of foreign source interest income earned by a foreign corporation engaged in the banking business is in derogation of this purpose of the Bill as set forth below:

1. At first appearances, it may seem equitable to tax foreign banking institutions on their foreign source interest income if such income is attributable to activities of an office or place of business in the United States since a domestic bank is taxed on its world-wide income including that derived from sources outside of the United States. However, upon closer analysis, it becomes apparent that domestic banking institutions have certain Federal income tax privileges which are denied resident foreign banks. For example, a domestic bank may claim annual deductions for additions to its reserve for bad debts until the reserve equals 2.4 per cent of loans outstanding at the close of the taxable year, regardless of whether its bad debt experience indicates that any losses, in fact, did result. (Rev. Rul. 65-92, 1965-1 C.B.: 112). A resident foreign bank, on the other hand, may only claim a deduction for those bad debts actually incurred, or a deduction for an addition to a reserve for bad debts based on a reasonable expectation that a percentage of loans will default under the normal rules set forth in Section 166. If, based on subsequent experience, such bad debts do not materialize, the addition to the reserve must be restored to income by the resident foreign bank. Since the primary source of earning income for any bank is the loaning of funds, a resident foreign bank is at a distinct disadvantage in comparison to a domestic banking institution.

2. However, the inequitable tax treatment between domestic and foreign banks goes much further. As a general rule, where a taxpayer corporation disposes of a capital asset at a gain, such gain is taxed at the reduced rate of 25 per cent. Any losses derived from the sale or exchange of capital assets are first offset against the gains from such sales and any excess may be carried forward for a period of five years and utilized against future gains from the sale of capital assets (Section 1212(a)). Any excess of losses over gains from the sale or exchange of capital assets may not be offset against so-called ordinary income taxed at the regular corporate tax rates. In the case of a domestic bank, however, if the losses of the taxable year from sales or exchanges of bonds, debentures, notes, or certificates, or other evidences of indebtness, issued by any corporation (including one issued by a government or political subdivision thereof), exceed the gains of the taxable years from such sales or exchanges, no such sale or exchange shall be considered a sale or exchange of a capital asset. (Section 582(c), Treas. Reg. Sec. 1.582-1(c)). This means that if the losses exceed the gains from the sale or exchange of such capital assets, a domestic bank secures the benefit of an ordinary deduction applicable against income taxed at the 48 per cent rate. A resident foreign bank may only deduct capital losses against capital gains taxed at the 25 per cent rate and any excess may only be carried forward for five years and charged against capital gains. If it does not have capital gains within such period or not sufficient gains to absorb such losses, the carryover can be lost forever. No deduction for capital losses is permitted against ordinary income.

3. A further area of inequitable treatment stems from the fact that domestic banks are allowed to deduct interest paid on deposits and other expenses incurred in earning tax-exempt interest. Interest income earned on obligations issued by any of the fifty states or their municipalities is exempt from U.S. income tax (Section 103). Section 265(2) sets forth the general rule that no deduction shall be allowed for interest on indebtedness incurred or continued to purchase or carry obligations, the interest from which is wholly exempt from Federal income tax. However, this rule does not apply to domestic banks. The provisions of Section 265(2) have no application to interest paid on indebtedness represented by deposits in banks engaged in the general banking business since such indebtedness is not considered to be "indebtedness incurred or continued to purchase or carry obligations . . ." within the meaning of Section 265. (Rev. Rul. 61-222, 1961-2 C.B. 58). Even though a domestic bank may use a portion of its deposits to purchase tax-exempt state or municipal bonds, the interest expense paid on such deposits is fully deductible without any allocation to the tax-exempt interest income. A resident foreign bank, on the other hand, is not accorded this same privilege. It may only claim a deduction for those expenses which are connected with earning taxable gross income from sources within the United States (Section 882(c)(2),

Treas. Reg. Sec. 1.882-3(b) and 1.873-1(a)(1). Section 861(a) which defines income from sources within the United States limits this concept to "items of gross income." Municipal and state bond interest is not included in "gross income" (Section 103).

Thus, to the extent that comparable interest expense on deposits and other expenses are attributable to tax-exempt bond interest income, they are not deductible by a resident foreign banking corporation, although a domestic banking institution can claim such deductions.

In the light of the foregoing we submit that to tax resident foreign banking corporations on their foreign source dividends, interest, and gains from the sale of securities does not achieve equitable tax treatment for their investments in the United States.

In addition, this novel concept of taxing foreign enterprises on their foreign source income is directly contrary to three-quarters of the Income Tax Treaties concluded by the United States with foreign countries which specifically limit U.S. taxation of foreign enterprises to their U.S. source income. (E.g., Australia—Article III, Italy—Article III.) The U.S. Treasury Department Regulations applicable to those few tax treaties whose provisions allow Federal taxation on all income allocable to a U.S. "permanent establishment," limit this rule to income from sources within the United States, thus evidencing the intent of even these treaties not to tax foreign source income. (E.g., Canada—Regulation Section 519.104, France—Regulation Section 514.105). Since Section 10 of the Bill provides that no amendment made by H.R. 13103 shall apply in any case where its application would be contrary to any treaty obligation of the United States, this motive to tax foreign source income would not apply to those countries with whom the United States has an income tax treaty, thus discriminating severely against those nations with whom the United States has not yet concluded a treaty. Since the United States has not concluded an income tax treaty with Hong Kong, our bank would be seriously affected under the proposed Bill in a manner not contemplated at the time these tax treaties were negotiated.

United States taxation of foreign interest income attributable to a U.S. place of business could result in multiple taxation under the Bill without a compensating offset for a foreign tax credit. Let us assume that the resident foreign bank is organized in country A having a corporate income tax rate of 48 per cent. Let us assume it earns interest income of $10,000 in country B who imposes a 15 per cent withholding tax thereon. The interest income is also attributable to the office in the United States and is taxed at 48 per cent. For purposes of simplification, we will assume that there are no deductible expenses and that the total taxable income subject to tax in country A is $110,000, including the $10,000 bond interest. We will also assume that country A has a per country limitation for foreign tax credits but no overall limitation. In other words, the amount of any credit for foreign taxes paid or accrued to any foreign country is limited to the ratio of taxable income from sources within that country to entire taxable income applied to the tax due before credit in country A. The following calculation sets forth the taxes paid to the respective countries after the suitable credits.

	Country A	Country B	United States
Taxable income	$110,000	$10,000	$10,000
Tax computed thereon	52,800	1,500	4,800
Less foreign tax credit	1,500		1,500
Net tax due	51,300	1,500	3,300

The effective rate of tax on the $10,000 of interest income is 81 per cent (i.e., 33% in country A, 15% in country B, plus 33% in the United States) instead of 48 per cent due to the fact that the credits are limited to the tax imposed by the country of source.

From the foregoing illustration, it is evident that the resident foreign bank will not secure a foreign tax credit in its home land for net United States income taxes paid. Furthermore, while Section 6 of the Bill permits a credit for foreign taxes paid or accrued on income from sources without the United States which is "effectively connected" with the conduct of a trade or business within the

United States, such credit is only allowed for the foreign tax levied by the country of source and not the country of organization. Therefore, no credit would be allowed in the United States for taxes paid to country A since the income is sourced in country B. As a result there would be multiple taxation due to the inability to claim full foreign tax credits.

Finally, it has always been fundamental to American democratic philosophy that the Federal government's right to tax is not based upon mere physical force but on the underlying theory that the consideration given for taxation is the protection of life and property, and that the income rightly to be levied upon to defray the burdens of government is that income which is created by activities and property protected by the government or obtained by persons enjoying such protection. (Mertens, Section 45.27). This basic tenet of tax philosophy is violated by the provisions of the Foreign Investors Tax Act that propose to tax foreign source income of a foreign corporation controlled by non-U.S. persons merely because it is deemed to be attributable to a United States place of business. The fact that a bill of exchange, promissory note, or bond, the instrument evidencing a debt, is physically located in the United States or is accounted for in the U.S., does not mean that the United States is protecting the property represented by that document.

The residence of the obligor determines the location of the property right, and it is that country who properly exercises the jurisdiction to tax the income earned thereon since it protects the property rights represented by the security. By the same token, the country of organization of the obligee may also choose to tax the income because it offers world-wide protection to the taxpayer entity. This latter country will generally allow a foreign tax credit for income taxes paid to the country of source, if it also chooses to tax the same income. Let us take the case of a typical resident foreign banking institution such as this taxpayer. It negotiates the purchase of overseas bonds through its Head Office in Hong Kong and the funds for the purchase are provided by the Head Office and not by the U.S. branches. The bonds are not governed by the laws of the U.S., none of the parties to the transaction are located in the United States, and all transfers of currency concerning principal and interest take place outside of the United States. Nevertheless, the resident foreign bank could be taxed in the United States on the interest income earned from these bonds simply because they are utilized in the United States as New York assets in setting credit limitations by the New York State banking authorities. Yet, the foreign bank cannot use the United States courts to enforce the property rights represented by these bonds, such as the payment of principal or interest. It must turn to the courts outside the U.S. for redress and protection. Furthermore, since the United States is not the country of organization, it does not offer world-wide protection to this entity, which is fundamental to the philosophy for taxing a U.S. entity on foreign source income.

To illustrate the principle, if the bonds were to be used to secure loans made in the United States, it would seem that the proper income to tax is the income generated by utilizing such loan funds, not the foreign source income earned by the security provided for such loans. In other words, it is the U.S. source income from such loans which is properly attributable to the U.S. place of business, not the foreign source income from the bonds used as security to obtain the loans. Therefore, it would seem that to tax the interest income derived from such bonds would be an undue extension of the authority of the Federal government in exercising its taxing jurisdiction.

It can also be seen that the above argument applies to any other evidence of indebtedness, such as a bill of exchange or a promissory note, where the obligor and obligee are foreign individuals or foreign entities and the income earned therefrom is foreign source income.

In conclusion, it is submitted that the Foreign Investors Tax Act will discriminate against resident foreign banking institutions instead of providing more equitable tax treatment for their investments in the United States. If Congress wishes to fulfill its stated objective, then it should choose between either not taxing resident foreign banks on their foreign source dividends, interest and gains from the sale of securities or else extend to them the same tax privileges accorded to domestic banks.

It is recommended that this inequity be corrected by excluding resident foreign banks from Section 864(c)(4)(B)(ii) added to the Internal Revenue Code by Section 2(d)(2) of H.R. 13103.

It is respectfully requested that, at such time as the Senate Finance Committee may hold a public hearing on the Foreign Investors Tax Act, The Hongkong and

Shanghai Banking Corporation be given an opportunity to orally express its views through its representative, Richard H. Kalish, partner in the firm of Peat, Marwick, Mitchell & Co. (Certified Public Accountants).

BARCLAY'S BANK D.C.O.,
New York, August 9, 1966.

H.R. 13103—Foreign Investors Tax Act of 1966.

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

DEAR SENATOR LONG: As a resident foreign bank, you can appreciate our interest and concern with the provisions of The Foreign Investors Tax Act which will affect the taxability of agencies and branches in the United States. Our primary concern is the provision of the Bill which would tax foreign source interest income attributable to a United States place of business under the "effectively connected" concept. Initially, it seemed quite equitable to tax foreign banking institutions on such foreign source interest income where it is earned through an office in the United States since a domestic bank is taxed on its world-wide income including that derived from sources without the United States. Upon a closer analysis of this proposed legislation in the light of other provisions of the U.S. tax law, however, it became quite evident to us that to tax a U.S. branch or agency of a foreign banking corporation would not, in fact, achieve the stated objective of the Bill "to provide more equitable tax treatment for foreign investment in the United States." While a domestically incorporated U.S. bank is taxed on its foreign source income, it nevertheless enjoys certain tax privileges regarding the deductibility of additions to reserves for bad debts, capital losses and expenses related to the purchase of state and municipal securities which are not available to resident foreign banks. Furthermore, where the country of organization or primary residence of the foreign banking corporation doing business in the U.S. does not permit a foreign tax credit for income which is taxed in the United States but not sourced here, the foreign bank will be subjected to a multiplicity of income taxes without tax credit relief. This would be true for any foreign nation which has a per-country limitation similar to that in the United States.

Accordingly, we requested our tax accountants, Peat, Marwick, Mitchell & Co., to prepare a statement for submission to your Committee outlining in detail the reasons for which we feel a resident foreign bank should not be taxed on its foreign source dividends, interest, and gains from the sale of securities which might be attributed to a U.S. branch or agency.

It is, therefore, respectfully requested that the Senate Finance Committee give careful consideration to the views expressed in the Statement which we are submitting herewith.

We should also be pleased to have Mr. Richard Kalish, Partner in the firm of Peat, Marwick, Mitchell & Co. (Certified Public Accountants) discuss this matter with you and other members of your committee and staff as you may see fit in the circumstances.

Yours very truly,

E. W. BITHELL,
Local Director.

STATEMENT OF BARCLAY'S BANK D.C.O.

INTRODUCTION

Barclay's Bank D.C.O. is a corporation organized under the laws of the United Kingdom in 1836, with its head office located at 54 Lombard Street, London E. C. 3, England. It is engaged in the commercial banking business with offices located throughout the world. In the United States it maintains branches in New York City at 300 Park Avenue and at 120 Broadway in addition to an office at 111 Pine Street, San Francisco, California. The bank is licensed to do business in New York State and the State of California. The stock of the corporation is widely held by foreign persons. Its banking business consists of servicing export and import operations, providing the necessary financing thereof, and offering many of the general banking services of a domestic bank. Since it operates through branch offices, it is permitted to accept deposits from customers whereas an agency cannot do so, although it may solicit them for its head office.

PRESENT LAW

A foreign corporation engaged in trade or business in the United States is taxed under section 882 of the Internal Revenue Code, which provides that such corporation shall be taxable in the same manner as a domestic corporation (that is, on its net income at the rates prescribed by Section 11 of the Code), except that it is only taxable on its income from sources within the United States. It is not taxable on income derived from sources without the United States. Those business expenses which are directly identifiable with United States source income are allowable deductions plus the allocable share of other expenses which are related to earning United States source income, but the amount of which cannot be specifically determined. In this latter case, the expenses are deductible in the ration of gross income from sources within the United States to the total income of the bank from all sources. (Section 861(b) and 882(c)(2) of the Code; Treasury Regulation Section 1.882-3(b)(2) and 1.873-1(a)(1)).

Interest income derived from a foreign government, a nonresident alien individual, a foreign corporation or other entity not engaged in trade or business in the United States is income from sources without the United States and is exempt from United States income tax. (Section 861(a)(1) and 862(a)(1)). Furthermore, interest income received from a resident alien individual, a resident foreign corporation (i.e. one engaged in trade or business in the United States), or a domestic corporation is also exempt from Federal income tax when such person derives less than 20% of its gross income from sources within the United States for the three preceding years or for the period of its existence if less than three years. (Section 861(a)(1)(B)).

PROPOSED LAW

The proposed Bill departs to a considerable extent from the foregoing principles and will have a serious and arbitrary effect on this taxpayer. Under the Bill in its present form, the gross income of a resident foreign corporation would be divided into two categories (H.R. 13103, Section 4(b)):

(1) Gross income which is effectively connected with the conduct of a trade or business within the United States;

(2) Gross income which is derived from sources within the United States and which is not effectively connected with the conduct of a trade or business in the United States.

The first category of income would be taxed at the regular corporate rates or 22% and 48% under Section 11 of the Code after an allowance for the permitted deductions (H.R. 13103, Section 4(b) amending Section 882(a) and (c)), or at the capital gain rate of 25% under Section 1201(a) of the Code. The factors to be taken into account in order to ascertain whether an item of income is "effectively connected" with the conduct of a trade or business in the United States are (H.R. 13103, Section 2(d)):

(1) The income gain or loss is derived from assets used in or held for use in the conduct of such trade or business, or

(2) The activities of the trade or business were a material factor in the realization of the income, gain or loss.

In determining whether either of these factors are present to render income as being effectively connected with the conduct of a United States trade or business, due regard shall be given as to whether or not the assets, income, gain or loss is accounted for through the United States place of business. (Proposed Section 864(c)(2) as set forth in Section 2(d) of H.R. 13103). While income from sources within the United States may be effectively connected with the conduct of a United States trade or business, only certain specified types of income from sources without the United States can be so treated. Of particular concern in this latter instance to Barclays Bank D.C.O. is the provision that dividends, interest, and gain or loss from the sale or exchange of stock, notes, bonds, or other evidences of indebtedness derived in the active conduct of a banking business within the United States would be subject to Federal income tax, if such income is "effectively connected" with an office or other fixed place of business within the United States. (Proposed Section 882(b)(2) as contained in Section 4(b) of H.R. 13103).

Income from sources within the United States, which is not "effectively connected" with the conduct of a trade or business in the United States, would be taxed at a flat 30% rate (or applicable treaty rate). As under present law applying to nonresident foreign corporations, no deductions would be permitted even though there may be expenses related to earning such income.

EFFECT OF H.R. 13103 ON U.S. BRANCH OPERATIONS

Most interest income earned by the U.S. branches of the bank, which could be subject to U.S. income tax, consists of interest on loans, overdrafts, investments and bills. Interest is also earned by way of discount which is, of course, another term for interest. By way of illustration, foreign source interest income attributable to a U.S. place of business might arise in the following manner:

1. A U.S. company (an exporter) draws a bill of exchange (i.e., a demand draft) on a United Kingdom company abroad. It presents the draft and documents (e.g. commercial invoice, bill of lading, consular invoice, certificate of origin, etc.) to the New York branch of the bank. The New York branch will type the details on covering schedules; instruct the London branch as to the manner in which the bill should be collected and what to do if the United Kingdom importer does not honor and pay the bill; and will remit the bill, documents and instructions to the London branch. The documents are placed in the hands of the drawee on the bill (the United Kingdom importer) only upon the instructions of the drawer of the bill (the U.S. exporter). The London branch will notify the United Kingdom importer, who examines the draft and documents, and, if all is in order, he will pay the amount of the draft to the London branch. The proceeds will be remitted to the New York branch for payment to the exporter. Sometimes the foreign importer is not in a position to pay the amount of the draft drawn by the U.S. exporter and the New York branch will advance the proceeds to the U.S. exporter charging the foreign importer with interest on the loan. In this case, the foreign source interest income would be effectively connected with the conduct of the U.S. banking business subject to Federal income tax under the Foreign Investors Tax Act.

2. A company organized in India (an exporter) might draw a bill of exchange payable in U.S. dollars (i.e. a 90 day time draft) on a Turkish importer. The steps in the transaction are similar to those set forth in the first case. The Indian company needs cash immediately and discounts the draft with the New York branch of the bank who remits the funds to its Bombay office. At maturity, the New York branch will collect the face amount of the bill and retain the proceeds, the discount earned representing interest income on the transaction. Since the proceeds of the draft are paid by the Turkish importer, the interest income is earned from foreign sources. It would be taxable in the United States since the assets of the New York branch were utilized to discount the bill for the foreign exporter.

3. A French shoe manufacturer not engaged in business in the United States might import raw hides from the United States. He opens a letter of credit through the Paris office of the bank in favor of the U.S. exporter. The letter of credit provides that upon presentation of the required draft and documents in accordance with the terms of the letter of credit, the exporter will be paid for the shipment. However, the French importer does not have the cash to cover the letter of credit and borrows the necessary funds from the bank. Where the New York branch pays the U.S. exporter, it is in effect making a loan to the French importer. The interest earned by the New York branch of the bank from this transaction is foreign source income since the payor is a foreign entity not engaged in trade or business in the United States.

4. Dollar loans might be made by the New York branch of the bank to a foreign government to be used to finance the construction of dams, electrical plants, schools and other facilities. The interest thereon would be foreign source income attributable to the U.S. place of business and subject to Federal income tax.

While there may be other types of transactions generating foreign source income attributable to a U.S. place of business, the foregoing illustrations point up the fact that there are many cases in which a foreign banking corporation engaged in trade or business in the United States can be subject to U.S. income tax on foreign source income under proposed Section 864(c)(4)(B)(ii). While we agree that this is undoubtedly one of the objectives of the Foreign Investors Tax Act, it is our view that such income should not be subjected to Federal income tax for the reasons cited below.

CONSIDERATIONS FOR EXCLUDING FROM TAX FOREIGN SOURCE INTEREST INCOME OF AGENCY AND BRANCH BANKS

The object of the Bill is "to provide more equitable tax treatment for foreign investment in the United States" as stated on page 1 of Report No. 1450 of the Committee on Ways and Means of the House of Representatives to accompany

H.R. 13103. We submit that the taxation of foreign source interest income earned by a foreign corporation engaged in the banking business is in derogation of this purpose of the Bill as set forth below:

1. At first appearances, it may seem equitable to tax foreign banking institutions on their foreign source interest income if such income is attributable to activities of an office or place of business in the United States, since a domestic bank is taxed on its world-wide income including that derived from sources outside of the United States. However, upon closer analysis, it becomes apparent that domestic banking institutions have certain Federal income tax privileges which are denied resident foreign banks. For example, a domestic bank may claim annual deductions for additions to its reserve for bad debts until the reserve equals 2.4 per cent of loans outstanding at the close of the taxable year, regardless of whether its bad debt experience indicates that any losses, in fact, did result. (Rev. Rul. 65–92, 1965–1 C.B. 112). A resident foreign bank, on the other hand, may only claim a deduction for those bad debts actually incurred, or a deduction for an addition to a reserve for bad debts based upon a reasonable expectation that a percentage of loans will default under the normal rules set forth in Section 166. If, based on subsequent experience, such bad debts do not materialize, the addition to the reserve must be restored to income by the resident foreign bank. Since the primary source of earning income for any bank is the loaning of funds, a resident foreign bank is at a distinct disadvantage in comparison to a domestic banking institution.

2. However, the inequitable tax treatment between domestic and foreign banks goes much further. As a general rule, where a taxpayer corporation disposes of a capital asset at a gain, such gain is taxed at the reduced rate of 25 per cent. Any losses derived from the sale or exchange of capital assets are first offset against the gains from such sales and any excess may be carried forward for a period of five years and utilized against future gains from the sale of capital assets (Section 1212(a)). Any excess of losses over gains from the sale or exchange of capital assets may not be offset against so-called ordinary income taxed at the regular corporate tax rates. In the case of a domestic bank, however, if the losses of the taxable year from sales or exchanges of bonds, debentures, notes, or certificates, or other evidences of indebtedness, issued by any corporation (including one issued by a government or political subdivision thereof) exceed the gains of the taxable year from such sales or exchanges, no such sale or exchange shall be considered a sale or exchange of a capital asset (Section 582(c), Treas. Reg. Sec. 1.582–1(c)). This means that if the losses exceed the gains from the sale or exchange of such capital assets, a domestic bank secures the benefit of an ordinary deduction applicable against income taxed at the 48 per cent rate. A resident foreign bank may only deduct capital losses against capital gains taxed at the 25 per cent rate and any excess may only be carried forward for five years and charged against capital gains. If it does not have capital gains within such period or not sufficient gains to absorb such losses, the carry-over can be lost forever. No deduction for capital losses is permitted against ordinary income of a resident foreign bank.

3. A further area of inequitable treatment stems from the fact that domestic banks are allowed to deduct interest paid on deposits and other expenses incurred in earning tax-exempt interest. Interest income earned on obligations issued by any of the fifty states or their municipalities is exempt from U. S. income tax (Section 103). Section 265(2) sets forth the general rule that no deduction shall be allowed for interest or indebtedness incurred or continued to purchase or carry obligations, the interest from which is wholly exempt from Federal tax. However, this rule does not apply to domestic banks. The provisions of Section 265(2) have no application to interest paid on indebtedness represented by deposits in banks engaged in the general banking business since such indebtedness is not considered to be "indebtedness incurred or continued to purchase or carry obligations . . ." within the meaning of Section 265 (Rev. Rul. 61–222, 1961–2 C.B. 58). Even though a domestic bank may use a portion of its deposits to purchase tax-exempt state or municipal bonds, the interest expense paid on such deposits is fully deductible without any allocation to the tax-exempt interest income. A resident foreign bank, on the other hand, is not accorded this same privilege. It may only claim a deduction for those expenses which are connected with earning taxable gross income from sources within the United States (Section 882(c)(2), Treas. Reg. Sec. 1.882–3(b) and 1.873–1(a)(1)). Section 861(a) which defines income from sources within the United States limits this concept to "items of gross income." Municipal and state bond interest is not included in "gross income" (Section 103). Thus, to the extent that com-

parable interest expense on deposits and other expenses are attributable to tax-exempt bond interest income, they are not deductible by a resident foreign banking corporation, although a domestic banking institution can claim such deductions.

In the light of the foregoing, we submit that to tax resident foreign banking corporations on their foreign source dividends, interest, and gains from the sale of securities does not achieve equitable tax treatment for their investments in the United States but serves to aggravate an inequity which exists under present law and would continue under the proposed legislation.

In addition, this novel concept of taxing foreign enterprises on their foreign source income is directly contrary to three-quarters of the Income Tax Treaties concluded by the United States with foreign countries which specifically limit U. S. taxation of foreign enterprises to their U.S. source income (e.g., Australia—Article III, Italy—Article III). The U. S. Treasury Department Regulations applicable to those few tax treaties whose provisions allow Federal taxation on all income allocable to a U. S. "permanent establishment," limit this rule to income from sources within the United States, thus evidencing the intent of even these treaties not to tax foreign source income (e.g., Canada—Regulation Section 519.104, France—Regulation Section 514.105). Since Section 10 of the Bill provides that no amendment by H.R. 13103 shall apply in any case where its application would be contrary to any treaty obligation of the United States, this motive to tax foreign source income would not apply to those countries with whom the United States has an income tax treaty limiting its taxing jurisdiction, thus discriminating severely against those nations with whom the United States has not yet concluded a treaty.

Furthermore, even though the United States may have an income tax treaty with the country of residence of a foreign banking corporation engaged in trade or business within the United States providing that only U. S. source income can be attributed to a permanent establishment in the United States (e.g. such as Article III of the 1946 United States-United Kingdom Income Tax Treaty in conjunction with Section 10 of H.R. 13103 allowing treaties to prevail; see also Houses Report No. 1450, page 121), a provision in the Internal Revenue Code which attempts to tax foreign source income of resident foreign-banks in non-treaty countries could set the stage for future abrogation of the treaties presently in force.

United States taxation of foreign source interest income attributable to a U.S. place of business could result in multiple taxation under the Bill without a compensating offset for a foreign tax credit. Let us assume that the resident foreign bank is organized in country X and pays tax at an effective corporate rate of 60 per cent. Let us assume it earns interest income of $500,000 in country Y which imposes a 15 per cent withholding tax thereon. The interest income is also attributable to the office in the United States and is taxed at 48 per cent. For purposes of simplification, we will assume that there are no deductible expenses and that the total taxable income subject to tax in country X is $1,500,000 including the $500,000 bond interest. We will also assume that country X has a per country limitation for foreign tax credits but no over-all limitation. In other words, the amount of any credit for foreign taxes paid or accrued to any foreign country is limited to the ratio of taxable income from sources within that country to entire taxable income applied to the tax due before credit in country X. The following calculation sets forth the taxes paid to the respective countries after the suitable credits:

	Country X	Country Y	United States
Taxable income	$1,500,000	$500,000	$500,000
Tax computed thereon	900,000	75,000	240,000
Less foreign tax credit	75,000		75,000
Net tax due	825,000	75,000	165,000

The effective rate of tax on the $500,000 of interest income is 93 per cent (i.e. 45 per cent in country X, 15 per cent in country Y, plus 33 per cent in the United States) instead of 60 per cent due to the fact that the credits are limited to the tax imposed by the country of source (Section 6(a) of the Bill adding Section 906, House Report No. 1450 at pages 37 and 38).

From the foregoing illustration, it is evident that the resident foreign bank will not secure a foreign tax credit in its home land for net United States income taxes paid since the interest income is not from U.S. sources. Furthermore, while Section 6 of the Bill permits a credit for foreign taxes paid or accrued on income from sources without the United States which is effectively connected with the conduct of a trade or business within the United States, such credit is only allowed for the foreign tax levied by the country of source and not the country of organization. Therefore, no credit would be allowed in the United States for taxes paid to country X since the income is sourced in country Y. As a result, there would be multiple taxation due to the inability to claim full foreign tax credits.

Finally, it has always been fundamental to American democratic philosophy that the Federal government's right to tax is not based upon mere physical force but on the underlying theory that the consideration given for taxation is the protection of life and property, and that the income rightly to be levied upon to defray the burdens of government is that income which is created by activities and property protected by the government or obtained by persons enjoying such protection (Mertens, Section 45.27). This basic tenet of tax philosophy is violated by the provisions of the Foreign Investors Tax Act that propose to tax foreign source income of a foreign corporation controlled by non-United States persons merely because it is deemed to the attributable to a United States place of business. The fact that a bill of exchange, promissory note or bond, the instrument evidencing a debt, is physcially located in the United States, is accounted for in the United States, or the United States office acquired it does not mean that the United States is protecting the property represented by that document. The residence of the obligor determines the location of the property right, and it is that country who properly exercises the jurisdiction to tax the income earned thereon since it protects the property rights represented by the security. By the same token, the country of organization of the obligee may also choose to tax the income because it offers world-wide protection to the taxpayer entity.

This latter country will generally allow a foreign tax credit for income taxes paid to the country of source, if it also chooses to tax the same income. Let us take the case of a Lebanese resident foreign banking institution. It negotiates the purchase of Chilean bonds through its head office in Lebanon. The loan is governed by the laws of Chile or Lebanon; the currency in which the bonds are payable is Chilean escudos; none of the parties to the transaction are located in the United States; and all transfers of currency concerning principal and interest take place outside of the United States. Nevertheless, the resident foreign bank could be taxed in the United States on the interest income earned from these Chilean government bonds simply because they might be held in the United States to secure additional lines of credit under the New York State banking laws or because the funds of the New York branch or agency were used to make the purchase. Yet, the foreign bank cannot use the United States courts to enforce the property rights represented by these bonds, such as the payment of principal or interest. It must turn to the courts in Chile or Lebanon for redress and protection. Furthermore, since the United States is not the country of organization, it does not offer world-wide protection to this entity, which is fundamental to the philosophy for taxing a U.S. entity on foreign source income. If the bonds are being used to secure loans made in the United States, it would seem that the proper income to tax is the income generated by utilizing such loan funds, not the foreign source income earned by the security provided for such loans. In other words, it is the U.S. source income from such loans which is properly attributable to the U.S. place of business, not the foreign source income from the bonds used as security to obtain the loans. Therefore, it would seem that to tax the interest income derived from such Chilean bonds would be an undue extension of the authority of the Federal government in exercising its taxing jurisdiction.

A similar situation exists with respect to other evidences of indebtedness, such as bills of exchange, drafts and promissory notes, where the obligor and obligee are foreign individuals or entities and the income earned therefrom is foreign source income.

In conclusion, it is submitted that the Foreign Investors Tax Act will further aggravate the present discrimination against resident foreign banking institutions instead of providing more equitable tax treatment for their investments in the United States. If Congress wishes to fulfill its stated objective, then it should choose between either not taxing resident foreign banks on their foreign source dividends, interest and gains from the sale of securities or else extend to them the same tax privileges accorded to domestic banks.

Such treatment would provide a reasonable solution to this inequitable situation, especially in view of the contribution made to the U.S. business community by foreign banking institutions as expressed in "Economic Policies and Practices—Paper No. 9—Foreign Banking in the United States" which is part of the materials prepared for the Joint Economic Committee Congress of the United States (Joint Committee Print, 89th Congress, 2nd Session):

"The recommendation for free entry and equal access for foreign banks appears to be supported by past performance. Especially in the States whose foreign banking laws are most liberal, both bankers and supervisory officials argue that the advantages gained by the States and the country as a whole far outweigh the disadvantages. The foreign banks have contributed to the development of New York and San Francisco as centers of international finance and trade. A by-product of this development has been the expansion of trade in which U.S. firms have been important participants and which several domestic banks have financed to an increasing degree. The foreign banking institutions have introduced new financial instruments in the trade financing field, and, thus, have complemented the activities of domestic banks. There has been little evidence or complaints of competitive developments unfavorable to the domestic banks, and most banks report improved correspondent relations since the establishment of foreign banking institutions here. In certain instances, the foreign banks have provided personal banking services to ethnic groups who otherwise would have been denied these services and who probably would have held some of their money outside the banking system. Finally, it has been noted that the existence of foreign banks here and branches and subsidiaries of U.S. banks overseas probably has had favorable payment effects."

It is recommended that this inequity be corrected by excluding resident foreign banks from Section 864(c)(4)(B)(ii) added to the Internal Revenue Code by Section 2(d)(2) of H.R. 13103. This may be accomplished statutorily by deleting the word "banking" from the phrase "and either is derived in the active conduct of a (banking), financing, or similar business . . ." set forth in Section 864(c)(4)(B)(ii), added by Section 2(d)(2) of H.R. 13103.

It is respectfully requested that, at such time as the Senate Finance Committee may hold a public hearing on the Foreign Investors Tax Act, Barclays Bank D.C.O. be given an opportunity to orally express its views through it representative, Richard H. Kalish, partner in the firm of Peat, Marwick, Mitchell & Co. (Certified Public Accountants).

Senator ANDERSON. Mr. Seath.

STATEMENT OF JOHN SEATH, VICE PRESIDENT AND DIRECTOR OF TAXES, INTERNATIONAL TELEPHONE & TELEGRAPH CORP.

Mr. SEATH. Mr. Chairman and members of the committee, my name is John Seath. I am vice president and director of taxes of the International Telephone & Telegraph Corp.

I appreciate this opportunity to appear before you to express my views on certain aspects of H.R. 13103.

The initial bill proposed by the Treasury Department as the forerunner of H.R. 13103 had as its primary objective the encouragement of foreign investment in the United States. This was, and is, an objective that merits the full support of your committee. To the extent that the United States can create a favorable climate for foreign investment within its shores, to that extent can we expect foreign countries to create a favorable climate for American investment abroad.

It seems to me that the original purpose of the bill, to encourage foreign investment in the United States, has become obscured in an attempt to extend U.S. income taxation to foreigners who have no U.S.-source income under the rules long established by the Congress. This can have little or no effect on our balance-of-payments situation.

My company has one of the largest U.S. investment abroad. It is deeply concerned with the U.S. balance-of-payments problems.

Senator ANDERSON. Where are you on your statement?

Mr. SEATH. I have submitted a longer statement and I am reading from a short statement which I thought you would prefer me to do rather than to read the long one.

Senator ANDERSON. We would like to have you do that, but we would like to know where you are. Have you any copies of that? Your full statement can go in the record.

Mr. SEATH. Yes, that was my thought.

Senator ANDERSON. Go ahead.

Mr. SEATH. We believe that this bill, to the extent that your committee can restore it to its original purpose of encouraging foreign investment to come to the United States, will significantly aid our balance-of-payments situation. But to accomplish this, I repeat, the bill has to be restored to its original objective. Only if that is done, can we reasonably expect this bill to increase the inflow of investment funds from abroad.

However, I should like to call the attention of this committee to what I believe is another significant aspect of our balance-of-payments problem. The foreign tax sections of the Revenue Act of 1962 were designed to encourage the repatriation of income derived by U.S. corporations from foreign sources. At the same time, the cost of repatriating that income was increased through the so-called "gross up" provisions. Section 904 of the Internal Revenue Code imposes a limit on the credit against the U.S. tax on foreign-source income which may be claimed by a U.S. taxpayer against his U.S. income tax for foreign taxes paid on the same income. Section 862 describes the method of allocating U.S. expenses against U.S.-source and foreign-source income. In 1944 the U.S. courts decided that the expense allocation rules of section 862 must be followed in determining the limits on allowable foreign tax credits under section 904. The net effect of this interplay is that many U.S. corporations operating with subsidiaries abroad are not receiving the foreign tax credits that we believe Congress originally intended. The result is that such corporations build up unused credits, are thereby encouraged not to repatriate earnings, and the U.S. balance-of-payments situation is not helped at all.

The Treasury Department, which recognized that there is an inequity here, a few days ago, after many months of promises, issued proposed revised regulations under section 862 which were supposed to ease the problems of excess foreign tax credits of U.S. corporations.

We have analyzed these proposed regulations and it is our opinion that, if it was their intent to ameliorate present harsh rules, they are a dismal failure. They do not ameliorate. They merely substitute complicated rules for simple rules without offering any relief at all. This harsh limitation on the utilization of foreign tax credits places U.S. corporations in a position of picking and choosing those foreign subsidiaries from which dividends will be paid on an annual basis in order to avoid the accumulation of unused and unusable foreign tax credits. The solution is a simple amendment to section 904 of the code providing that only expenses directly related to the production of the foreign income will be allocated against foreign income in determining the limitation on the foreign tax credits. This avoids complicated or unnecessary rules proposed by the Treasury. And it brings dollars back to the United States.

I have prepared a more detailed statement which I have submitted to the clerk of the committee as I do not wish to burden the committee with a lengthy oral presentation.

Thank you. I have submitted a more detailed statement.

(The document referred to above follows:)

STATEMENT OF JOHN SEATH, VICE PRESIDENT AND DIRECTOR OF TAXES OF INTERNATIONAL TELEPHONE & TELEGRAPH CORP.

Mr. Chairman and members of the Committee, my name is John Seath and I am Vice President and Director of Taxes of International Telephone and Telegraph Corporation.

You are holding hearings today on H.R. 13103, the Foreign Investors Tax Act of 1966, which is subtitled "A bill to provide equitable tax treatment for foreign investment in the United States." I am certain that from all the testimony you have heard and will hear on this bill, some doubts will be created whether the bill does, in fact, accomplish this objective.

The Treasury Department which strongly supports the bill has repeatedly stated that the bill is part of the President's program to improve the United States balance of payments. I am here to urge consideration by your Committee of an amendment which will, I submit, substantially encourage repatriation by domestic corporations of earnings of foreign subsidiaries and thereby directly improve our balance of payments situation.

As your Committee may well know, many U.S. corporations are already in difficulties because they have foreign tax credits currently unusable in part because of the interpretation of the present foreign tax credit provisions of the Internal Revenue Code. Understandably, these corporations are reluctant to withdraw from foreign subsidiaries further dividends which carry with them a high foreign tax liability not currently creditable in full against U.S. tax liability. This potential excess tax liability serves severely to inhibit dividend repatriation, and the U.S. balance of payments situation is thereby adversely affected.

I respectfully urge your Committee to consider an amendment to the bill which will eliminate this impediment to the withdrawal of dividends from foreign subsidiaries. Not only would such an amendment restore the foreign tax credit limitation to the interpretation followed by the Internal Revenue Service prior to two court decisions some twenty years old, but it would give substantial assistance to taxpayers seeking to support the economic policies of the United States. It is believed that any loss in revenue to the Treasury will be far outweighed by the increased flow of foreign earnings to the United States.

A basic principle of the foreign tax credit is that a taxpayer is allowed a credit against U.S. tax not to exceed the ratio that its foreign taxable income bears to its entire taxable income, both foreign and domestic. However, an unintended quirk in the interpretation of the tax law cuts down the maximum foreign tax credit allowable by reducing the numerator of the limiting ratio. This results because indirect expenses (expenses not allocable to a specific class of income) must be allocated to dividends received from foreign subsidiaries, even though no portion of the expenses is properly applicable to such dividend income. In spite of our treaty program, this leads to double taxation since the foreign country imposing the tax properly allows no deduction for such expenses. The effect of this rule is not limited to dividend income; it applies to all foreign income, but its most extreme application is against foreign dividend income.

As a result, many U.S. corporations, if they wish to rapatriate earnings from their foreign subsidiaries, have to pay an aggregate U.S. and foreign tax liability substantially in excess of the tax paid on the same amount of income by corporations operating entirely in the United States. This can easily be illustrated by the following examples:

Assume a domestic corporation realizes gross income of $150 from sources within the United States and $100 from sources without the United States (either foreign royalties of $100 on which $48 of foreign taxes were paid, or dividends of $52 from its foreign subsidiary which amount, after gross-up, is treated as $100 of foreign dividend income since the subsidiary paid $48 of foreign taxes with respect to the dividends). (It should be noted here that the gross-up provisions of the 1962 Revenue Act substantially increase the tax distortion caused by the present foreign tax credit computation rules.) Assume, further, that the foreign income was received without any expense and that the domestic corporation has $30 of overhead expenses (concededly not incurred in respect of the foreign royalties or dividends). Under present law, the United States tax (at 48% rate) would be computed as follows:

	Foreign	Domestic	Total
Income	$100	$150	$250.0
Allocated deductions	12	18	30.0
Taxable income	88	132	220.0
U.S. tax before credit ($220 at 48 percent)			105.6
Amount of foreign taxes ($48 available) creditable after limitation $\left(\frac{\$88}{\$220} \times \$105.60\right)$			42.2
U.S. tax after credit			63.4
Total taxes paid: $48 foreign, plus $63.4 United States			111.4
or			
Total taxes on same amount of U.S. income			105.6
Excess taxes paid			5.8

Thus, $250 of gross income from domestic and foreign sources bears a significantly higher tax than the same amount of income would have borne if entirely from domestic sources.

This problem is further compounded by the effect of foreign withholding taxes on dividends paid to U.S. taxpayers. When such withholding rates are added to already high foreign tax rates, the foreign tax burden in many countries is substantially greater than the U.S. tax burden. The Treasury position on expense allocations substantially increases this burden, with the result that the withdrawal of foreign earnings is discouraged by the high tax cost.

Under an amendment which would require that foreign income be reduced only be expenses directly related thereto the U.S. tax would be computed as follows:

	Foreign	Domestic	Total
Income	$100	$150	$250.0
Deductions		30	30.0
Total	100	120	220.0
U.S. tax before credit ($220 at 48 percent)			105.6
Amount of foreign taxes ($48 available) creditable after limitation $\left(\frac{\$100}{\$220} \times \$105.6\right)$			48.0
U.S. tax after credit			57.6
Total taxes paid: $48 foreign, plus $57.6 United States			105.6
or			
Total taxes on same amount of U.S. income			105.6

It is submitted that the latter result reached under the proposed amendment is the proper one. The total tax paid by the U.S. corporation is equal to the tax that would be paid by a domestic corporation with the same amount of taxable income arising from operations solely in the United States. This result is one of equitable tax treatment, the basic objective underlying both the long-standing foreign tax credit provisions of the Internal Revenue Code, the foreign income provisions of the Revenue Act of 1962, and the provisions of the bill now before your Committee.

That the present rule is unfair and capricious has even been recognized by the U.S. Treasury Department which has given repeated assurances that new income tax regulations would be issued to correct the admitted inadequacies of the present regulations.

On August 2, 1966, the new regulations were issued in proposed form. An analysis of the proposed rules indicates that they in no way to resolve the problems. To the extent that they were intended to alleviate an admittedly unfair situation, they fail completely. The new proposed rules spell out in broad general language standards to be used in determining which deductions are to be apportioned to U.S. and foreign income on some form of "reasonable basis" and which deductions are to be apportioned across the board to U.S. and foreign income based on mechanical gross income ratios. But this amplification of language appears to be a mere gloss on the existing regulations. No ameliorative changes have been made.

To the extent that a taxpayer wishes to show that his directly incurred U.S. expenses relate to U.S. income and not to foreign income, there is little in the regulations to aid him. Expenses not directly connected with foreign income are still to be allocated to such income, and the inequities of the existing regulations continue substantially unchanged.

In the typical situation where a domestic parent performs services for a foreign subisdiary, the proposed regulations tie in to the new Section 482 regulations and state that expenses are to be apportioned to the gross income that the taxpayer gets or should get under the new regulations under § 1.482–2 for performing such services.

Under § 1.482–2(b) (3) of the new proposed regulations, the cost of the services is equal to the arm's length charge for such services which must be taken into account by the person rendering the services. Presumably, if the expenses of the services are greater than the amount charged, the taxpayer will have to take into account additional taxable income against which income there will be applied, for foreign source taxable income determination, the expenses incurred.

While it is difficult to follow the reasoning involved in the proposed rule requiring allocation of expenses incurred by a domestic corporation for its subsidiary to some sort of imputed reimbursement received from the subsidiary for the services rendered, two examples given in the proposed regulations indicate the impossibility of applying the proposed rule to the affairs of a large corporation.

In Example (1), a domestic corporation is said to have incurred $60,000 of direct selling expenses and $40,000 of indirect expenses (executive salaries, rents, utilities, expenses of staff departments, etc.) on behalf of its foreign subsidiary which amount is reimbursed by the foreign subsidiary which also pays a dividend of $90,000. According to Example (1), the $100,000 of expenses is allocated to the $100,000 of reimbursement and none of this $100,000 is allocated to the dividend income. However, whatever reason and sense there may be in Example (1) is completely nullified by Example (3) which points out that Example (1) does not take into account other significant corporate expenses. Under Example (3), the president's salary and other indirect expenses related thereto, as well as interest expense on general indebtedness, must be apportioned to foreign income on "some reasonable basis," while expenses for U.S. income tax return preparation and expenses for meetings of the U.S. parent's board of directors and shareholders must be apportioned to foreign income on the basis of gross income ratios.

The net effect of all this, it is respectfully submitted, is that the taxpayer has been taken up the hill and down the hill and back to the old rule. The new examples and the confusing complex generalities of language that the new regulations contain merely perpetuate the old, admittedly inequitable rule which, at least, had the advantage of simplicity: direct expenses are allocated to items of income to which they directly relate and indirect U.S. expenses are allocated on the basis of gross income ratios to foreign source income.

The basic question is whether this old rule is right or wrong, fair or unfair, in limiting available foreign tax credits to U.S. corporations operating abroad. These corporations have maintained that the old rules are unfair, hurt the taxpayer and, indirectly, the United States. And the Treasury Department has, in large measure, stated that it agrees with the taxpayer's complaints.

If this be so, it is submitted that the basic rule needs to be changed by legislation and not perpetuated by confused, camouflaged regulatory language which, by design or accident, serves merely to perpetuate admitted inequities.

Gentlemen, I respectfully urge your consideration of an amendment to the bill to accomplish this objective.

Thank you for the opportunity to appear before you.

Senator ANDERSON. Senator Carlson.

Senator CARLSON. Just this, Mr. Chairman.

Mr. Seath, you mentioned this proposed revised regulation or these revised regulations under section 862 which were supposed to ease the problems of excess foreign tax credits of U.S. corporations, and then you come down to the point and suggest that we amend section 904 of the code providing——

Mr. SEATH. That is right, sir.

Senator CARLSON (continuing). That only expenses directly related to the production of the foreign income will be allocated against foreign income in determining the limitation on the foreign tax credits.

Now, that is not, of course, in the pending House bill, but it is your suggestion that we do that as we act on this legislation, is that it?

Mr. SEATH. That is right, sir.

The point is that if you try to amend section 862 you get into other ramifications of the code because it would hurt in other areas or do damage that should not be done. But section 904 is the section that governs the limitation of foreign tax credits and, by simply amending that to provide that only expenses directly allocated, directly related, to the earning of the income should be allocated against the income, then you do not do any damage to any other section of the code.

Senator CARLSON. It sounds very simple, so I suppose we had better look at it when we get to it.

Mr. SEATH. Thank you.

Senator ANDERSON. Senator Dirksen.

Senator DIRKSEN. Do you make the point that the Internal Revenue Code does discourage the repatriation of foreign income?

Mr. SEATH. Very definitely, sir; very definitely, sir. You see, when you have to allocate, for example, the cost of the general headquarters in New York against a dividend from some country, foreign country, in determining the amount of the foreign tax credit allowable, then you have to examine how much dividends you should bring in; so, you would have to balance the tax rate in country A, the tax rate in country B, versus the tax rate in country X, so that you can work out an average tax rate which will permit you to bring in a certain amount of income and not allocate so much expense against it that your foreign tax credits are lost.

Senator DIRKSEN. How does your proposed amendment operate to obviate that?

Mr. SEATH. What I propose, sir, is that we change the section of the code, 904, which governs the limitation on foreign tax credits, to provide that only expenses directly related to the production of the foreign income be allocated against foreign income in setting the limit on foreign tax credits.

Senator DIRKSEN. You think that the complicated rules to which you refer also discourage repatriation of foreign income?

Mr. SEATH. Well, they do not change what is the present rule. You see, in 1944 the courts decided that you should allocate all expenses against both domestic and foreign income, and ever since then that has been the rule.

These new proposed regulations of the Treasury that I referred to do not change the rule as far as we can understand them.

Senator DIRKSEN. Aside from this, what other provisions are there in the code that make it difficult for income to come back?

Mr. SEATH. Well, it is a pretty lengthy thing. The limitation is the primary one. The other thing that is more of a harassment than anything else, the information sections of the code, in effect, cost the United States money.

I file with my returns each year a stack of paper, information on foreign subsidiaries, about that high, which is completely useless.

Senator DIRKSEN. You better say how high because the reporter cannot put that gesture down.

Mr. SEATH. About a foot to a foot and a half high, which is completely useless.

What has happened is, in the Revenue Act of 1962—and I have no brief for evaders of our tax or avoiders of our taxes—we set up a monster in the subpart F section of the code and, in order to try to effectuate that monster, they had to get information sections of the code and, as I say, I file a stack of paper about a foot and a half high that is of absolutely no use because our subsidiaries are primarily suppliers of equipment to their local government. A supplier of equipment to a local government cannot be a tax haven.

Senator DIRKSEN. In proportion to foreign earnings that do not come back, it would actually have an adverse, rather than a beneficial, effect on the balance-of-payments problem.

Mr. SEATH. Very definitely, sir.

One example—I was talking about the balancing of credits—Chile, for example, has a tax rate of 30 percent, but they have a withholding rate of 37½ percent. When you put that together that exceeds the U.S. rate. When you also allocate expenses against that income you increase the effective Chilean rate to something way up in the 60- to 70-percent rate against a 48-percent U.S. rate, so it makes it quite a mess.

The CHAIRMAN (presiding). What do you think about these Treasury regulations on section 482, the allocation of income and deduction on taxpayers? The Treasury has been asking for a long time that they have more time to study the problem you raise about the repatriation of some of this money earned overseas. Does that help you with your problem?

Mr. SEATH. No, sir; it certainly does not. They are long, they are complicated and, to the best of our study and our ability to analyze them, they have not done a thing. All they have done is to create complications, but they have not helped a bit.

The CHAIRMAN. You do not find that to be helpful then?

Mr. SEATH. Not a bit.

The CHAIRMAN. You have said the Internal Revenue Code discourages repatriation of foreign earnings. Will you be a little more explicit as to how that works out in your case?

Mr. SEATH. Yes, sir. I was starting to speak to that point just a minute ago. I used the example of Chile which has an income tax of 30 percent and a withholding tax of 37½ percent. When you put those two together, you have got an effective rate that is pretty high.

When you have to allocate——

The CHAIRMAN. It is 67½ if you add them.

Mr. SEATH. Straight addition.

For a non-gross-up country, which Chile is, that is the way it works out. If it were a gross-up country, it would not quite work out that way. But when you have to allocate U.S. expenses against that income, the net income decreases, the tax does not decrease.

Therefore, the effective rate of tax goes up again so you wind up with an effective rate of tax up in the seventies.

Now, when you bring money in from Chile at this very high rate you are discouraged from bringing it from another country with a high rate because you have to look around all of your subsidiaries to find a low rate, such as Switzerland, which is a low rate, to bring some in from Switzerland to balance them so you do not wind up with excessive credits which you cannot use and probably will never use.

The CHAIRMAN. In other words, you have money overseas that you would like to bring in but in one respect or another you cannot earn enough credits?

Mr. SEATH. We have got lots of credits, but their usability is destroyed by this allocation of U.S. expenses against the foreign-source income.

The CHAIRMAN. I see.

Mr. SEATH. This indiscriminate allocation of U.S. expenses against foreign-source income.

The CHAIRMAN. So the way the law is written you have a lot of credits that you cannot use because of the way they make you allocate your costs.

Mr. SEATH. That is right.

The CHAIRMAN. That being the case, you are just forced to leave the money over there until you are in a position to use those credits because they are worth something to you if you can use them.

Mr. SEATH. That is right.

The CHAIRMAN. If you bring the money in, and you have to pay the tax on it, you cannot use those credits, what tax do you pay here?

Mr. SEATH. You do not pay any tax when you have excess credits, Senator.

The CHAIRMAN. No, I mean when you cannot use them. You have excess credits.

Mr. SEATH. That is right.

The CHAIRMAN. You cannot use them.

Mr. SEATH. That is right.

The CHAIRMAN. So you are just sitting around waiting until some day when you can use them.

Mr. SEATH. That is correct.

The CHAIRMAN. Suppose you went ahead and brought the money in and left the credits behind you.

Mr. SEATH. Yes.

The CHAIRMAN. What tax would you pay here then?

Mr. SEATH. I would not pay any tax here. What I would do is to create a situation if and when these credits expired, and I had a time when I did not have enough credits, I would have to pay a tax that I should not have had to pay.

The CHAIRMAN. Well, all I am asking, is why you do not bring the money back.

Mr. SEATH. That is exactly the point I was making.

The CHAIRMAN. All I want to know is what would happen to you if you did. You are not going to bring it back, I presume, because you would pay a lot of taxes against which you would not get the benefit of your credits.

Mr. SEATH. No, that is not quite the point. The point is that if you bring it back you will not pay any tax to the United States now, but you will create a situation where these foreign tax credits will expire, and when they have expired you will be in a situation very possibly where you will have to pay taxes that you would not have to pay if you did not bring the money home.

The CHAIRMAN. You mean pay taxes here then?

Mr. SEATH. Yes; yes, sir.

The CHAIRMAN. That you would not have to pay if you had not brought the money home.

Mr. SEATH. Yes.

Senator MCCARTHY. So you do not bring it back.

Mr. SEATH. That is right, so we do not bring it back.

The CHAIRMAN. What rate of tax would that be that you would pay, that you otherwise would not have to pay if you did not bring the money back?

Mr. SEATH. Well, the U.S. rate is 48 percent now. The question——

The CHAIRMAN. It is less than that against Chile, is it not?

Mr. SEATH. Well, the U.S. rate is 48 percent. Now, Chile, with credits running up to 70 percent, you do not pay anything.

Senator MCCARTHY. If you can use the credits.

Mr. SEATH. If you can use the credits——

Senator MCCARTHY. The point is when you did have to pay, the credits that you might otherwise have used would be canceled, and you would have to pay the regular rate on whatever the difference was.

Mr. SEATH. That is right. It depends entirely on timing.

The CHAIRMAN. Well, now, are there any other provisions of the code that discourage repatriation, to your knowledge?

Mr. SEATH. I do not think there are sections that really discourage repatriation. They are more, as I said to Senator Dirksen, they are harassing sections, but not really discouraging sections. In other words, we have to file tremendous volumes of information, which costs us a lot of money, and which is useless except for statistical purposes. It does not produce any revenue for the United States.

The principal thing, in my opinion, is to put the foreign tax credit situation in a usable state, a useful state, and eliminate some of the uncertainties. We never know exactly what is going to happen to us where we have things like these new regulations which are exceedingly complicated.

There are many revenue agents around the country, and no two of them think the same way. You give them something that is exceedingly complicated, and you never know where you are going to come out, and that is why I think something simple like this amendment would do the job.

The CHAIRMAN. Senator Anderson.

Senator ANDERSON. I was just curious as to why you appear here on this hearing; what do you want us to do with the bill?

Mr. SEATH. I think you ought to amend the bill for what I was talking about here, and I also think you ought to put the bill back in the original shape the Treasury proposed it. In other words, you ought to be going back to the original proposal of the Treasury which would encourage foreign investment in the United States.

Senator ANDERSON. Specifically, which section then would you change?

Mr. SEATH. For one, I would eliminate this "effectively connected" language completely from the bill. The "effectively connected" is a new concept. It is, again, indefinite; it is a subjective test, it is not an objective test; and when you put language like "effectively connected" into the hands of the many revenue agents there are around the country, you are going to get almost as many interpretations of the words "effectively connected" as there are revenue agents.

Senator ANDERSON. Well, on a matter of this nature, wouldn't it be much better around the country if it all came into one place?

Mr. SEATH. Around the country, it would be all over the country, sir. All these provisions in this bill will ultimately be in the hands of the thousands of revenue agents around the country who audit taxpayers' returns, and it is their job to apply that language.

Senator ANDERSON. But they have to concern themselves with only one type income, do they not, which is foreign income?

Mr. SEATH. Yes, sir. They examine all different kinds of tax returns. They just do not limit themselves to one type of income.

Senator ANDERSON. I am trying to think what the average agent would do with your tax account.

Mr. SEATH. Pardon me, sir?

Senator ANDERSON. I am wondering what the average agent would do with your tax account that would not get them involved in my State or his State? What are you worried about?

Mr. SEATH. That is right. We get an agent; one agent will take one position, and another agent will take another position. The court case in 1944 which changed the interpretation of the Internal Revenue Service which it had put in the rules for many, many years prior to that time was the thought of one revenue agent. It was not a thought of the Internal Revenue Service, but he bulled it through, and it became the law of the land, and even today, sir, this allocation of expenses against foreign source income is not uniformly applied. There are many corporations today which have foreign-source income, and when they are determining the utilization of the foreign tax credits under limitation they do not allocate U.S. expenses against the foreign-source income because it is an abstruse provision of the code and not a well understood one.

The CHAIRMAN. Senator McCarthy.

Senator MCCARTHY. I have no questions.

The CHAIRMAN. Senator Morton.

Senator MORTON. Sir, I think it is clear that the Treasury Department wants to recapture as much foreign earnings as we can for reasons of balance of payments.

Mr. SEATH. Right.

Senator MORTON. And your point is that their regulation today fails to recapture as much?

Mr. SEATH. They fail to encourage it.

Senator MORTON. Encourage the recapture.

Mr. SEATH. That is right; that is right.

Senator MORTON. Do you think that it would require an amendment to this bill to see that we recapture or encourage to recapture these foreign earnings? Has your experience been with regulation that you are not getting it and that now you need positive legislation from the Congress?

Mr. SEATH. That is my experience, sir; yes, sir. I think we very definitely need, as I stated—we have been promised by the Treasury that they would amend their regulations to give the help we need.

Now, we have seen the proposed regulations and they just absolutely do not do anything. They just substitute complicated rules to say the same thing as the old simple rules say. It is just another way of saying "No." The only way we are going to get what we need is by legislation.

Senator MORTON. It strikes me this is one of the most serious problems that we face today, this question of balance of payments and if, indeed, and I know you are knowledgeable on this subject, if indeed, by regulation we are discouraging the recapture of funds earned abroad, which is bound to help our balance of payments, it seems to me if we could capture them, if we indeed are discouraging them, perhaps this committee should take some action along the lines of your proposal.

Mr. SEATH. Well, that is my position. I think we are discouraging the repatriation of foreign earnings by this present situation. I think if we changed the law to this extent it will definitely encourage the repatriation of foreign earnings.

I have talked with a number of taxpayers around the country, and I think the sentiment is unanimous that such a change would encourage additional repatriation of foreign earnings.

Senator MORTON. I do not like to ask you to speak for others, but is the position which you have taken today supported by other industries and businesses that are in your situation?

Mr. SEATH. Yes, sir; that is very definitely true.

Senator MORTON. I apologize for not being here during your direct testimony. It is understandable that sometimes constituent problems in a State like mine, politically balanced as it is, take a little bit of my time.

Mr. SEATH. I believe that, sir.

Senator MORTON. I have read it, and I commend you for it, and I think you have made a significant point that this committee certainly should consider because here we are worried today about this balance-of-payments thing more than anything else, and you say, and you speak with authority and knowledge on this subject, that the regulations of our own Treasury Department are discouraging the recapture of these earnings.

Mr. SEATH. That is correct, sir.

Senator MORTON. I trust and hope, and I know the committee will take this very seriously, consider it very seriously. I thank you.

Mr. SEATH. Thank you.

Senator CARLSON. Mr. Chairman, I have a suggestion. Mr. Seath has mentioned we should amend section 904. I would appreciate very much if—this is somewhat of a technical amendment that someone will probably work with—if he would come up with a suggested amendment, at least let us look at it.

Mr. SEATH. All right, sir; I will do that.

Senator CARLSON. I, for one, would like to see it.

Mr. SEATH. I will get it up here as quickly as I can.

(The suggested amendment referred to, follows:)

PROPOSED AMENDMENT

SECTION —. LIMITATION ON FOREIGN TAX CREDIT

Effective with respect to taxable years ending after December 31, 1965, subsection (c) of section 904 (relating to limitation on foreign tax credit) is amended to read as follows:

"(c) *Taxable income for purposes of computing limitations.*—For purposes of computing the applicable limitation under subsection (a)—

"(1) *In general.*—The taxable income from sources within a foreign country or possession of the United States or from sources without the United States shall be computed under section 862(b), except that no expenses, losses, or other deductions shall be deducted from gross income from such sources unless such expenses, losses, or other deductions can directly be allocated to some item or class of such gross income, and

"(2) *Personal exemptions.*—The taxable income in the case of an individual, estate, or trust shall be computed without any deduction for personal exemptions under section 151 or 642(b)."

The CHAIRMAN. Mr. Seath, the best I can say is you have a good argument. It is not your fault that the law is so complicated. We made it that way, with an assist of the Treasury Department. If we can understand it enough to see just precisely what we are doing, I think there is a prospect that we might really give you some relief.

Mr. SEATH. Thank you, sir.

The CHAIRMAN. The next witness is Mr. Gordon Henderson, New York State Bar Association Tax Section.

STATEMENT OF GORDON D. HENDERSON, COMMITTEE ON INTERNATIONAL TAXATION, NEW YORK STATE BAR ASSOCIATION TAX SECTION

Mr. HENDERSON. Mr. Chairman and members of the committee, my name is Gordon Henderson. I am a partner in the law firm of Root, Barrett, Cohen, Knapp & Smith in New York City.

I am appearing before you today on behalf of the Committee on International Taxation of the New York State Bar Association Tax Section.

Mr. David Simon, chairman of the committee, had planned to be here to testify before you today. He is presently in the West, however, and because of the airline strike has been unable to get here.

The CHAIRMAN. What, I ask, is the matter with railroads? I used to be able to get on a train in New York and get down here in 4 or 4½ hours.

Mr. HENDERSON. As I say, Senator, he is out in the West, and he is about a 3-day train ride away.

The CHAIRMAN. I see. He is out in the West. I did not understand it.

Mr. HENDERSON. So I am here today to testify in his place.

The CHAIRMAN. Senator Anderson says that a 3-day train ride sounds like it must be somewhere out on the ocean.

Mr. HENDERSON. It is out West.

Senator ANDERSON. The westerners on the committee know you can get to the committee in less than 3 days if you have good luck.

Mr. HENDERSON. On the train?

Senator ANDERSON. Yes.

Mr. HENDERSON. Gentleman, the Committee on International Taxation has focused its attention on that portion of H.R. 13103 which extends the Federal income tax to certain foreign source income of foreign corporations having offices in the United States.

On August 2, the chairman of the tax section forwarded to you a detailed report of our committee on this aspect of H.R. 13103. That is the report I am holding here in my hand, copies of which you have all received. I shall today only briefly comment on some of the major overall issues raised in that report, but I would like to request that the complete report be included in the printed record of these hearings.

The CHAIRMAN. Well, that is kind of hard to do. You are bringing us something that I am sure is a well-thought-out document. But it is—I'm just trying to find where you quit numbering these pages—you get up to 108 pages and then you start numbering all over again. [Laughter.]

As I understand it, you have 19 more pages.

Senator MCCARTHY. They have some in Roman numerals in the beginning.

The CHAIRMAN. Couldn't you just make a number of extra copies available to the committee so there would be copies for those who wanted to read it? It seems to me this would be a lot easier reading if we can keep it with our files. You know, most Senators get to where their eyesight is not too good after they reach a certain age, and your print is a lot superior to what we would get if it were put into the printed hearings. There is a lot more white space to look at now than if we put it in the printed record. I would suggest that we print your summary, which is about 9 pages, and then those who wanted to read this 125-some-odd-page brief, could get the rest of it from the committee files. We will have it here for them.

Mr. HENDERSON. That would be fine.

The CHAIRMAN. I am sure it provides a lot of fine information.

Mr. HENDERSON. All I can say is it took a great deal of work to prepare.

The CHAIRMAN. We might be able to find a few members of this committee who can take time to do it justice. I myself intend to take the report home and read it, for it does look very impressive and worth while.

Mr. HENDERSON. I hope I can provide just a brief summary of some of the highlights of it here.

The CHAIRMAN. Right.

Mr. HENDERSON. Then members of the committee and the staff can go into the portions of it that they wish to study further.

The CHAIRMAN. We will print the summary of it, and for those Senators who would like to read the rest of it, we will make it available to them. I am sure a lot would rather sit down and read your printing of the report than to look at it in the committee record, because the size of the type in the committee record makes for awfully tough reading.

(The summary referred to above follows:)

[From the report "Analysis of Proposed U.S. Taxation of Foreign-Source Income of Foreign Corporations" by the Committee on International Taxation of the New York State Bar Association Tax Section]

SUMMARY OF REPORT AND MAJOR RECOMMENDATIONS

The principal features of our Committee's Report are presented below in capsulated form.

A. INTRODUCTION

Under existing law, foreign business corporations are taxable by the United States only on income from U.S. sources. Relatively objective tests have evolved for determining the "source" of specific categories of income (see pp. 2–3).

The Bill would also tax three categories of foreign-source income: (1) rents or royalties for the use abroad of patents, copyrights and other intangibles; (2) certain banking and financing income received from foreign issuers and obligors; and (3) income from certain sales of goods, title to which passed outside the United States. The test in each case it whether the particular item of foreign-source income was "attributable" to a U.S. office. However, in the case of non-import sales of goods, no U.S. tax would be imposed if a foreign office "participated materially in such sale".

No additional revenue is expected to result from the proposed tax on foreign-source income.

B. POLICY QUESTIONS PRESENTED

The Report of the House Ways and Means Committee* gives two policy reasons for the proposed tax on foreign-source income: (1) to prevent the United States from being used as a "tax haven" by foreign corporations which avoid both all U.S. tax and most foreign tax, and (2) to impose a U.S. tax on "income generated from U.S. business activities".

Our analysis of the Bill in relation to these policy objectives raises doubts as to whether they have been consistently applied in the Bill in the form enacted by the House on June 15, 1966. In particular, there are no exceptions in the Bill to assure that its application would be limited solely to those foreign corporations which are substantially availed of to reduce foreign taxes. Our Committee believes that consistency with the Bill's "tax haven" theory would require provisions equivalent to various exceptions contained in Subpart F (see pp. 13–14).

The Bill also fails to implement in consistent fashion its theory that, for tax purposes, income is "generated" by office activities. If the theory is valid, it would seem to require changing the source-of-income rules to treat as foreign-source income the portion which is "generated" by foreign office activities. The Bill does not do this, and our Committee urges that further consideration be given this question (see pp. 14–17, 65–6).

There is also a question as to whether, under the Bill, the income taxed by the United States would be limited to the portion fairly allocable to the services rendered by the U.S. office. Our Committee recommends that for this purpose the equivalent of a Section 482 type of allocation be employed, in order to allocate to the U.S. office an amount equal to the fee or commission for the services rendered in the United States which it would have earned at arm's length if it had been a separate entity (see pp. 18, 55–7, 61, 65, 84–5).

Serious policy questions are also raised by conflicting U.S. income tax treaties with eighteen countries, which would bar the proposed tax on foreign-source income (see pp. 19–20). Treaties with other countries would allow the tax, but only if a Section 482 type of allocation was employed to determine the amount of income subject to the tax (see pp. 20, 57–9). Our Committee recommends further study of these treaty problems in order to assure that the proposed new tax would not operate in a disparate manner among different countries (see pp. 21, 63).

C. PRACTICAL PROBLEMS

Of special importance are the difficult problems of proof raised by the Bill (see pp. 22–8, 49–51, 73–4, 77). Tracing the "activities" of offices in the United States and abroad could be interpreted to require detailed records of negotiations and

*H. Rep. No. 1450, 89 Cong., 2d Sess. (April 26, 1966).

other matters not ordinarily reflected in branch books. Under that interpretation, it would seem necessary for foreign corporations to maintain records of office "activities" for each separate transaction of sale, lease, license, loan, etc., or run the risk of being taxed on worldwide income in these categories. This novel record keeping could prove exceedingly burdensome for such corporations, even though little or no tax is involved.

Another difficulty is the problem of double taxation, which arises from the fact that the foreign-source income proposed to be subjected to U.S. taxation would often be taxed by the country of source or by the country of incorporation. The Bill would limit the type of foreign tax for which a tax credit, or a deduction, would be permitted. Our Committee recommends that this limit on use of the credit be removed (see pp. 86–9).

The creation of these practical problems and burdens might compel foreign corporations either to alter, or eliminate, their present office arrangements in the United States (see pp. 30–3). Our Committee questions whether this is the intended result and, if so, whether it has real policy advantages for the United States.

D. SALE OF GOODS

This important category is considered first in regard to foreign-to-foreign sales (pp. 35–43) and next in regard to export and import sales (pp. 43–66).

In the case of foreign-to-foreign sales, the Bill is not clear as to whether the proposed new tax is intended to apply where a foreign office or other foreign fixed place of business has "participated materially" either by producing the goods abroad or by performing abroad other substantial economic activities essential to the foreign-to-foreign sale. Our Committee recommends that in both instances the Bill be clarified to confirm that there would be no U.S. tax, since the economic "center of gravity" is located abroad. (A suggested draft amendment is set forth at pages 42–3.)

In the case of export and import sales, the proposals in the Bill would interlace in complex fashion with existing law (see the Tables at pp. 45–6). Our Committee recognizes that any recommendations in this area must be premised on the larger policies which Congress seeks to pursue in regard to U.S. export and import trade. Should such trade be burdened by new taxes and, if so, to what extent? Does uniform application of the new rules require that their enactment be deferred until conflicting tax treaties have been revised?

Assuming that immediate enactment is considered advisable, however, our Committee strongly urges a number of major changes to mitigate difficult problems of proof, avoid serious inequities and anomalies, and simplify administration. These recommendations are set forth in detail at pages 64–66.

E. BANKING AND FINANCE INCOME

Foreign banks perform important functions in the United States, utilizing branches, agencies, representatives and correspondents (see pp. 68–70). The proposed tax on banking and financing income "attributable" to a U.S. office is ambiguous in its application to foreign banking operations in the United States. As a result of the close intertwining of foreign and U.S. banking arrangements, the Bill may deter foreign banking activities that are essential to our domestic economy (see pp. 71–7). It also raises problems as to foreign banks held by domestic Edge Act subsidiaries of domestic banks (see pp. 77–9).

Our Committee believes that the proposed new rules have not received adequate study and should not be enacted in their present form. If they are to be enacted, our Committee urges that an exception be made where a foreign banking office materially participated in the transaction; suggestions are also made for simplifying the determination as to such material participation by a foreign office (see pp. 79–80).

F. ROYALTIES FROM PATENTS AND OTHER INTANGIBLES

It appears that the proposed tax would turn on whether negotiation of the license took place in the United States, with no allocation for the economic values represented by the development, acquisition, ownership and management of the licensed property (see pp. 82, 84). In our Committee's view this rule—if we understand it correctly—would produce unwarranted economic results because it would allocate to the United States far more royalty income than was actually "generated" here. Our Committee believes that in no event should the U.S. tax consequences of a business transaction performed by a U.S. branch of a foreign corporation be more onerous than would be the case if such U.S. branch were separately incorporated.

Accordingly our Committee recommends here—as elsewhere—that a Section 482 method of allocation be used to determine the fee or commission that would have been paid at arm's length for the services rendered by the branch if it were a separate entity (see p. 84). This would avoid an inconsistency with many existing treaty obligations which require that this method of allocation be followed (see p. 85).

G. FOREIGN TAX CREDIT

With respect to the foreign tax credit, our Committee makes a number of technical suggestions intended to minimize the risk of double taxation inherent in the Bill as presently framed (see pp. 86–94).

H. PROPOSED LIBERALIZATION OF SECTION 904(f)

The Bill proposes some liberalization, subject to narrow restrictions, with respect to the present limitation on foreign tax credit treatment of interest income from foreign sources. Our Committee urges that further liberalization is needed in order to prevent arbitrary treatment of interest income derived by domestic corporations from indirect as well as direct investments in foreign corporations (see pp. 95–103).

I. RETROACTIVE APPLICATION OF PROPOSED "U.S. OFFICE" TEST

Our Committee recommends that if the proposed "U.S. office" test is to be adopted, the Bill should be amended to make it clear that no tax would be imposed by reason of any U.S. office "activities" occurring prior to the Bill's effective date, January 1, 1967.

Mr. HENDERSON. Our committee focused on this one aspect of the bill because we felt it presented particularly serious problems which the Congress should consider, but which did not appear previously to have been analyzed in depth.

One of the reasons for the previous lack of analysis would appear to be a widespread unawareness of the existence of these provisions in the bill.

I might add that it is the experience of our committee members that even today few in the business community and even few tax lawyers appear to be aware of the existence of these provisions. They know that H.R. 13103 is intended to carry out the Fowler task force recommendations of liberalizing and simplifying the tax treatment of foreign investors, particularly individuals, but they have not examined the bill with care and have not become aware that it contains these complex provisions which would add a new tax on certain foreign business activities in the United States.

These new provisions would impose a tax on three categories of foreign-source income deemed "effectively connected" with the U.S. office of foreign taxpayers.

The policy reasons given for these provisions in the House report are, first, to prevent the United States from being used as a "tax haven" and, second, to impose a U.S. tax on income "generated" from U.S. business activities.

As explained in detail in our report, the new tax would apply, however, even where no tax haven situation is involved. Nor does the bill apply in a consistent or equitable fashion its theory that the described income should be taxed where it is "generated." For example, the bill would subject, to U.S. tax, income it considers "generated" by U.S. office activities—but would not allow taxpayers to exclude from U.S. tax, or even to claim a foreign tax credit for, income similarly "generated" by a foreign office.

There is also a serious question whether the income taxed by the United States under this new provision would, under the bill, be limited to the portion fairly allocable to the services performed in the U.S. office.

Indeed, unless a section 482 type of allocation formula were added to the provision, this aspect of the provision might simply become a trap for the unwary, and for the small taxpayer, since it could perhaps be avoided in many cases by the formation of a separate subsidiary to conduct the activities of the U.S. office.

Serious policy questions are also presented by the fact that the new provision is in direct conflict with most of the present U.S. tax treaties with foreign countries. The new tax would be prohibited by 18 percent or proposed treaties, and treaties with 8 other countries would prohibit the new tax unless a section 482 type allocation formula were employed to determine the tax.

This conflict with our tax treaties is nowhere mentioned in the House report.

Since most of our treaties are with developed countries, the effect of this conflict would be to cause the new tax to apply primarily to taxpayers from the less-developed countries—unless and until the existing treaties were amended.

You had a concrete example of this pointed out to you earlier this morning by Mr. Kalish when he talked about the problems of banks in Puerto Rico.

An important policy question is, therefore, presented whether the Congress should adopt a provision which would apply in such a discriminatory fashion and against less-developed countries. So far as we are aware, however, this policy question has not yet been examined.

Of particular importance are the very great recordkeeping and compliance burdens which the new provision would place on taxpayers.

First, the provision contains many vague terms which would present difficult interpretative problems in applying them to concrete business situations.

In addition, taxpayers would have to keep complicated and extensive records, records which are not presently necessary for business reasons, in order to comply with the new provision. I might point out for your consideration that this recordkeeping and compliance aspect is described in concrete detail with factual examples on pages 22 to 28 of our report, and I think that portion you might find particularly interesting to read.

Senator ANDERSON. Senator McCarthy just pointed out to me the items on pages 26 and 27, one, two, three, four, up to eight, and two, three, five, two, three, six, eight and on down. Can you explain that to us?

Mr. HENDERSON. That is the example that I was referring to, Senator; yes, indeed.

Senator ANDERSON. What does it mean in connection with this bill?

Mr. HENDERSON. It means in connection with this bill that any foreign taxpayer who would have to determine whether a U.S. tax would apply to his foreign-source income effectively connected with his U.S. office would have to keep a whole new set of records in order to permit his counsel and his accountants and auditors to determine what portion of his income was taxable under this new bill. It means enormous recordkeeping problems for taxpayers, enormous new complications which are not now present.

We have tried to illustrate this by this concrete example. It shows, when sales of goods are made and a U.S. office may be involved, that under the present system of the tax code there are only two code numbers you would have to put on an invoice. One is for "Did the title pass in the United States?" Two is for the reverse, "Did title pass abroad?"

But under this new bill you would have to code eight different factors on your invoices, most of which involve very difficult questions of judgment. These are the eight factors listed on page 26. Some clerk would have to make a determination as to which of these factors applied to the particular sale, and that is a very difficult problem.

The CHAIRMAN. In the absence of a computer it would take almost forever to do that, would it not? In other words, you have to decide, one, did title pass in the United States, and you mark that down. Then, two, did the title pass abroad? Well, if title passed here, it did not pass there, so let us say you are under No. 1 on that. No. 3 is the trade attributable to the U.S. office.

Mr. HENDERSON. Senator, I would like to stop you there because I would like you to think of the practical problem of instructing a clerk in an office how to decide whether the sale was "attributable" to a U.S. office. I am afraid we lawyers could write reams of memorandums and documents trying to interpret what the word "attributable" means and there would be just an enormous problem of properly communicating this to a clerk who is going to have to apply it.

He is going to have to decide what is attributable.

The CHAIRMAN. So, as a practical proposition, if you had to hire a lawyer and pay lawyer's wages to make all these judgments, it would not be worth making a sale to begin with.

Now, if you are going to hire a clerk to do it, it is almost impossible to train a person working at clerk's wages to understand all of this well enough to make these decisions, I would take it.

Mr. HENDERSON. That is right, Senator. This imposes a real problem for taxpayers and their counsel and auditors because auditors and lawyers are going to insist that the clients have well-trained people who can handle this determination because tax returns have to be prepared and they have to be prepared properly.

The CHAIRMAN. You mean this bill we have before us would require all these decisions?

Mr. HENDERSON. Yes, sir; that portion of the bill which would tax "effectively connected" foreign-source income; that is the provision we are talking about.

The CHAIRMAN. "Effectively connected foreign-source income."

Mr. HENDERSON. Foreign-source income.

The CHAIRMAN. All right. Now, would you mind showing me how a clerk would do these requirements under pages 26 and 27; how you would go about making up, arriving at these decisions? I just want to understand what you have to do in order to comply with it so I can decide on that section.

Mr. HENDERSON. Yes, sir. Well, let me start with an example.

The CHAIRMAN. First, you have to decide whether the title passed in the United States, I take it?

Mr. HENDERSON. That is normally a very simple question of property law. Taxpayers do that now, and one of the great attributes of that provision is that it is simple. You can understand it.

The CHAIRMAN. That one is. So title passed abroad, you can decide whether it passed that way, 1 or 2.

Mr. HENDERSON. 1 or 2 is very simple.

The CHAIRMAN. How about the next one?

Mr. HENDERSON. The clerk would have to decide whether the sale was "attributable" to the U.S. office. To know that, you cannot normally tell it from a piece of paper. He would have to talk to the officer of the company or the salesman, whoever had made the sale, and ask him how the sale was made, where did the property come from, how did it arise, where did it go, who in the organization worked on the sale, did someone from the U.S. office work on the sale.

If someone from the U.S. office worked on the sale, what did he do with respect to the sale; did he simply send the paper record of the sale on Hong Kong to Great Britain after it had stopped here in the mail or did he talk to a customer who passed through the United States? Just what did he do? What were his activities?

After he finds out these facts, which we lawyers know are not always easy to assemble completely, he would then——

The CHAIRMAN. That is the kind of a thing that causes a salesman in an ordinary retail store to fall out with the boss and two salesmen to fall out with each other. If you go into a store, are waited on by one salesmen and then the regular salesman gets into the act, and you finally buy a necktie, and you wind up with the question of who is entitled to the commission for making that sale.

Mr. HENDERSON. Yes, sir.

The CHAIRMAN. Oftentimes it is left in dispute among the people as to who is responsible for the sale or maybe the manager comes up and gives you a discount or the question comes up of what part did each person play in making that sale. That is one which is very difficult to decide.

Mr. HENDERSON. That is right. I would like to point out, Senator, that this problem would apply even to foreign-to-foreign sales. In other words, take, for example, a Philippine corporation making sales into Canada and also into the United States, which has an office, let us say, in Seattle in which there is a salesman.

Let us take a sale made from the Philippines to Canada shipped directly by ship from the Philippines to Canada. The clerk would have to find out whether the salesman in the U.S. office had anything to do with that foreign-to-foreign sale. If he did there would then have to be a value judgment as to whether his activity made the sale "attributable" to the United States and subject it to this new U.S. tax. That is the practical problem on that.

The CHAIRMAN. All right. Let us take the next one, item 5, destination United States. I guess that is easy enough to determine.

Mr. HENDERSON. Well, there is a question under the bill of what the test "destination" means. We have used that word "destination" here to simplify it, but the question under this bill would be whether the product was coming into the United States to rest here, to be consumed here, to be used here, and, you know, there are problems today under subpart F of determining whether goods are received for consumption in a particular country or whether they may be reshipped and resold out of the country. That is a problem under items 5 and 6.

The CHAIRMAN. Destination abroad, then, would be in there. Now, No. 7, material participation by office abroad.

Mr. HENDERSON. The problem with that factor is, Senator, that under the bill it is unclear whether participation by the office abroad in anything but a salesman's sense is important. For example, assume you manufacture goods in the Philippines and your only salesman is in the Seattle office. He handles all sales to Canada as well as to the United States. Since there is no salesman in the Philippines, there is a question under the bill whether the manufacturing activity in the Philippines is deemed a "material" participation in the "sale," which would exempt a Philippines-to-Canada sale from U.S. tax. That is the first question of interpretation, and it is a very serious question.

I think that the view of the Treasury may be that only the sales activity is the important activity; that manufacturing activity or substantial trading activity in the foreign country will not be deemed a material participation in the "sale."

So the first question about the material participation in the sale factor that would have to be determined by regulations or by the statute is what the statute means by the word "sale."

Let us assume the statute means that only a sales activity is a material activity abroad. If that is what it means then our clerk would have to decide, if we now add to our example a salesman in the Philippines office, whether the activity by the salesman in the Philippines office as opposed to the activity of the salesman in the U.S. office in Seattle was a material aspect in the sale.

I think you can understand that this is not a very simple question to decide. We can easily state the general phraseology, but if you put yourself in the lawyer's position or the clerk's position you have to make the decision of what, in fact, is "material."

Senator MCCARTHY. You are talking now about something that was manufactured primarily in the United States?

Mr. HENDERSON. Outside the United States. But there are also problems where you have trading rather than manufacturing corporations abroad. For example, take the case of a corporation located abroad which does not manufacture abroad but which provides designs and so forth to subcontractors there which manufacture goods for it. It buys the goods with title passing abroad, say in the Philippines or any other country you want to name, and then sells those goods to another foreign country or, in part, to the United States, and it has an office here. In the case of sales to a foreign country you would have the question of what is material participation. Is it only sales activity, as mentioned before, or can it include other activities? Whether or not it includes other activities, what is material? Do you gage this by a time factor? By a salary factor? By a property factor? What is the factor or factors that determines whether it is material? It is simply not an easy question to decide. To get clerks to make these decisions is not going to be very easy.

Senator McCARTHY. Do you know where this amendment came from? Has it been around in academic circles or have lawyers been using it in international tax problems for some time?

Mr. HENDERSON. I do not know, Senator, what the origin was.

Senator McCARTHY. Are there courses in international taxation in Harvard which have been given through the years, do you know?

Mr. HENDERSON. This provision, has it been considered?

Senator McCARTHY. This proposition of money earned in international trade—did it come to you as a complete surprise when it was put into the House bill?

Mr. HENDERSON. This particular language and particular provision is new, but down through the years there has been discussion at the tax bar and Treasury staff and Congress staff and elsewhere about the source-of-income rules—which are the present rules in our code which determine what income is taxable here and what income is not taxable here—and people have various ideas and have had through the years about whether there ought to be amendments to the source-of-income rules.

The American Law Institute, when the 1954 code was being adopted, as we mention in an appendix here to our report, gave some consideration to possibly changing our source-of-income rules; and they finally decided after 2 years of study of the problems involved that they would not recommend any change in them.

The source-of-income rules have been in the code, I think, since 1917.

This provision which is in here dealing with "effectively connected" foeign-source income properly sshould be considered as an amendment to the source rules.

The CHAIRMAN. May I just say this to you, sir? My impression is that there is no greater economic waste and no greater waste of good brainpower in this country than the unnecessary complexity of American tax laws. I suppose we probably sop up more of America's brains with needless complications in these tax laws than with anything else. For what we gain in income on taxation of foreign income, the fantastic amounts of executive, legal, accountant, and clerical talent that we put to work on it, is probably a prime example of economic waste.

Think of all the fantastic amount of brainpower it takes to work all these kinds of things out when there must be some simple way to do it.

Mr. HENDERSON. I have always thought, Senator, when the Treasury makes computations of the collection costs of tax moneys, and determines what the percentage of the collection costs is to tax moneys received, that we really ought to add the private taxpayers' expenses in getting tax advice and handling the paperwork involved, before we really know what the effective cost of tax collection is. This particular provision here would cause an enormous amount of additional complexity. But it would not produce additional revenue.

Senator ANDERSON. And would we not have a lot of lawyers unemployed if we simplified the code?

Mr. HENDERSON. Well, I suppose they would have less to do, Senator; that is right. But it would nonetheless have a good effect on the economy if we simplified it.

The CHAIRMAN. Some of them might be capable of being air space mechanics or something like that, areas of employment where there is a shortage.

Mr. HENDERSON. That is right.

Senator ANDERSON. Well, you, for example, are worried about the word "attributable."

Mr. HENDERSON. Yes, sir.

Senator ANDERSON. Is "attributable" in the code of taxes anywhere else?

Mr. HENDERSON. It may be, Senator. I cannot remember.

Senator ANDERSON. Has it caused any crisis?

Mr. HENDERSON. Well, every time you have a word that is vague dealing with allocations——

Senator ANDERSON. You think "attributable" is vague?

Mr. HENDERSON. Yes, sir; absolutely.

Senator ANDERSON. Then you said "destination" was vague.

Mr. HENDERSON. Well, "destination" in the concept used in the bill; yes, sir.

Senator ANDERSON. You do not think they would know where they would ship everything?

Mr. HENDERSON. Everybody knows where goods start to be shipped. The next question is what does the consignee of the goods intend. Does he intend to use them in that country, or is he going to take them and sell them out of the country?

Senator ANDERSON. Have you ever had a problem arise on the question of destination in the filing of an income tax return?

Mr. HENDERSON. Personally I have not dealt with the destination problem but I have dealt with allocation problems.

Senator ANDERSON. Do you know of a lawyer who has dealt with the destination problem?

Mr. HENDERSON. I cannot specifically name a lawyer, but I am sure there have been. There are problems under subpart F, if you read the regulations, which deal with destination. It is a concept which is very difficult as a concept to work out. When you ship an automobile, for example, to Seattle from Germany, is it clear that the automobile is going to be used in the United States or is it possible that it might be traded off—before it is sold for retail—to a Canadian dealer in British Columbia.

Senator ANDERSON. Most people who have enough money to send an automobile from Germany to Seattle will know where to use it.

Mr. HENDERSON. I am sorry, I did not hear that.

Senator ANDERSON. I say most people who have enough money to have a car shipped from Germany to Seattle would know where it is going to be used.

Mr. HENDERSON. But the shipper may not know it. Let us take the case of the German distributor who ships from Germany to Seattle. If he were to carry through the destination for use in U.S. concept, he would at least have to ask the dealer in Seattle whether the car was to be sold at retail in Seattle or sold at wholesale to a Canadian dealer before he could determine whether or not he would owe U.S. tax on that car.

Senator ANDERSON. How would a Canadian dealer be able to determine what would be the shipment from Seattle?

Mr. HENDERSON. There are many cases where goods come from abroad and are temporarily stored in the United States and then shipped abroad. These kinds of problems come up and there are many litigated cases involving this problem in connection with import taxes and State taxes, and this happens quite frequently.

Senator ANDERSON. I have listened to many hearings where enormous problems are outlined, and then somehow the bill would get passed and not a thing would happen.

Mr. HENDERSON. I do not know that this would be true of this provision.

Senator ANDERSON. You think this might be subject to some confusion?

Mr. HENDERSON. Yes, sir. These pages 22 to 28 we have just been talking about are one example.

The CHAIRMAN. I would just instruct the clerk to insert in the record, starting at subsection (c) on page 25 in this presentation through the middle of page 28. I think that illustrates the problem.

(The section referred to follows:)

(c) EXAMPLE OF RECORDKEEPING DIFFICULTIES

As a hypothetical example, take the case of a Spanish corporation which purchases sherry from Spanish vintners through an office in Spain, and sells it to customers throughout the world. Some orders are solicited and accepted by the Spanish headquarters office. Others are solicited by branch offices in major cities throughout the world, forwarded to Spain, and accepted or rejected there. Shipment is made either from Spain or from warehouse stocks in other countries. The New York branch office solicits orders in the eastern half of the United States, Canada and Mexico, but certain large accounts deal directly with the office in Spain.

The consequence of this operation under existing law would be the taxation of the net profits of those sales in which title passed in the United States. Record keeping would involve coding invoices with the numbers 1 or 2 to designate whether title passed in the United States or abroad.

Under H.R. 13103, it would be necessary to use a coding system that would reflect much more information. Perhaps the simplest system would involve coding each invoice with a four digit number, such as 1357, 2368, or 2457, which would convey the following information:

1—Title passage in United States.
2—Title passage abroad.
3—Attributable to United States office.
4—Not attributable to United States office.
5—Destination United States.
6—Destination abroad.
7—Material participation by office abroad.
8—No material participation by office abroad.

The four-digit numbers made up from these code would indicate taxability or nontaxability according to the following schedule:

Taxable:
1 – – –
2 3 5 –
2 3 6 8

Nontaxable:
2 4 – –
2 3 6 7

The codes would be placed on the invoices by clerks in the sales offices, working from instructions issued by the tax department. Those instructions would require a review by the coding clerk of all "activities" in *each* office of the foreign corporation to determine whether that office conducted substantial "activities" with respect to the sale being coded. At return filing time, the tax deparment would call for a report of all invoices coded 1——, 235—, and 2368, together with information about the cost of the goods sold, and the "expenses, losses, and other deductions properly apportioned or allocated thereto * * *" Reg. § 1.861-1(a)(1). The tax department would then develop further information and, in some fashion, determine "a ratable part of any other expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income." Reg. § 1.861-8(a). The taxable income would be that computed from these figures.

The decisions required in coding the invoices point up the practical bookkeeping problems presented by H.R. 13103. As explained earlier, the most troublesome choices would be in deciding whether a sale is to be coded 3 (attributable to a United States office) or 4 (not so attributable), and whether there is (7) material participation by a foreign office or (8) no such participation. In practice it would also be most difficult—and perhaps impossible—to determine whether the ultimate "use, consumption, or disposition" of the goods (5) is in the United States or (6) abroad, since goods consigned to a purchaser located in the United States could be reconsigned or reshipped by him to a destination in Canada or elsewhere; unless the taxpayer has unusual sources of information, he might be taxed on the income from such transactions even though the law does not require it.

For further discussion of problems of proof, see pages 50-51, *infra*. For recommendations to mitigate these problems, see pages 64-65.

The CHAIRMAN (reading):

As a hypothetical example, take the case of a Spanish corporation which purchases sherry from Spanish vintners through an office in Spain, and sells it to customers throughout the world. Some orders are solicited and accepted by the Spanish headquarters office. Others are solicited by branch offices in major cities throughout the world, forwarded to Spain, and accepted or rejected there. Shipment is made either from Spain or from warehouse stocks in other countries. The New York branch office solicits orders in the eastern half of the United States, Canada, and Mexico, but certain large accounts deal directly with the office in Spain.

The consequence of this operation under existing law would be the taxation of the net profits of those sales in which title passed in the United States. Record keeping would involve coding invoices with the numbers 1 or 2 to designate whether title passed in the United States or abroad.

Under H.R. 13103, it would be necessary to use a coding system that would reflect much more information. Perhaps the simplest system would involve coding each invoice with a four-digit number, such as 1357, 2368, or 2457, which would convey the following information:

And then it is broken down in eight ways, and then a four-digit number would be made up from these codes to indicate taxability or nontaxability according to the following schedule which I will let the record show. The code would be placed for use by that department. This is no effort just to confuse. What you are saying here is that to try to arrive at a proper answer to a tax problem this would appear to be the simplest way that your people think that they could administer this particular provision of the law. This is not a matter of unduly confusing. This is just how they think they could best go about complying with this particular section of the bill before us.

Mr. HENDERSON. That is right, Senator. We tried to go through the mechanical steps in determining, if the bill were enacted, what the taxpayer would have to do in order to comply with the bill; how could he mechanically collect the data on the basis of which a tax return could be prepared; and it was our feeling this had to be done, this amount of detail had to be gone into.

The CHAIRMAN. That sounds like a complicated version of the problem we had with entertainment expenses. We came up with the conclusion that people were properly entitled to deduct certain entertainment expenses. Most folks, and that includes myself, do not like to carry a pad in their pockets to try to keep up with everything they spend on entertainment. So there had been accepted in years gone by the so-called Cohan rule permitting a taxpayer to estimate what he was paying out, and as long as he could appear to substantiate the estimate on a reasonable basis, the Internal Revenue Service would accept that. But there were a lot of people cheating on this, so the Treasury then said, "We want everybody to itemize it."

So what we came up with, to save any deduction at all for very legitimate expenses, was a proposition where each taxpayer would be expected to carry around a notebook and pad to note down who he entertained, where he entertained, what was the business relationship, and whether he entertained in a situation where there was music entertainment or whether he entertained in a situation where there was no music, no entertainment, where the discussion of business would be more appropriate. Of course, you would have to take each one of those items and analyze each one of them individually to decide whether each one was deductible, and that is a simple version of the kind of problem you are posing here applied to individual transactions.

Mr. HENDERSON. That is right, Senator. There are some areas in the tax law where, you know, additional complications have to be put in from time to time to produce fairness or proper tax revenue, and so on. It is not easy to have a completely simple code, but it is important that we not add complicating provisions that we do not really need. And we feel that because of the practical and policy questions raised by these provisions that we have just been discussing, that they should be considered very carefully by your committee before any action is taken.

I won't go into any more detail on our report. The detail is there, but I think what I have said, and what the detailed analysis in the report contains, indicate that there are very important questions raised by this portion of the bill—the portion which would impose a new tax on the so-called "effectively connected" foreign source income of foreign corporations—regarding its standing under the general policy objectives which Secretary Fowler has stated for the bill as a whole.

First, for example, this provision would not seem to create an additional simplification of the tax on foreigners. This is the point we have just discussed. Rather it would make such taxation more complex and burdensome.

There are other provisions of the bill which would, of course, simplify the tax treatment of foreigners, and this is an important goal because it does encourage foreign investment in a country if the tax rules applied to foreigners are simple and easy to understand.

Second, the new provision would not seem to create a more rational or equitable treatment for foreigners, either. Rather, the provision would apply in inconsistent and discriminatory ways.

Third, it would not seem to eliminate barriers to investment in the United States and to encourage new foreign investment and business activities here. Rather it would seem to impose a new barrier and to discourage new and even existing foreign investment and business activities in the United States. Thus, this provision would seem to have a harmful rather than a helpful effect on our balance-of-payments position.

Despite these negative aspects, the new provision would not appear to offer any positive contribution of tax revenue. The revenue estimates in the House report indicate that no additional revenue is actually expected to be produced by this new provision.

We believe these practical and policy questions should be fully explored and considered before this portion of the bill is enacted into law. We hope our detailed report will be of assistance to you in this connection.

I might note that Secretary Fowler has urged this committee to see that this bill is adopted at this session of Congress, because of the salutary portions of it which would help our balance-of-payments situation.

Because of the time pressure which immediate enactment would present to this committee and to the Congress, however, we would like to suggest that the committee consider eliminating from the bill, the portion we have just discussed, namely, the portion that would put a new tax on foreign-source income of certain U.S. taxpayers, and the putting of that provision over for a later and more thorough consideration.

Thank you.

The CHAIRMAN. Senator Anderson.

Senator ANDERSON. Is it possible under our present tax laws for a foreign corporation to establish a sales office in the United States, employ U.S. sales representatives, carry on a very active sales campaign in the United States, sell the goods to U.S. citizens in competition with U.S. industry, and yet pay no U.S. tax because of arrangements for title to pass outside of the United States?

Mr. HENDERSON. Yes, sir.

Senator ANDERSON. It can happen?

Mr. HENDERSON. It is equally possible, Senator, for a taxpayer to have all of the activities you just mentioned abroad, but pass title to the goods in the United States, in which case he is subjected to a U.S. tax, and the U.S. tax code does not say that that income becomes attributable to the foreign office. Now, this bill would attach a new U.S. tax——

Senator McCARTHY. Not many people are doing that, are they?

Mr. HENDERSON. On sales of goods because of the title passage rule it is usually possible to avoid that kind of situation. But in other situations covered by the bill it may not be easy to avoid that kind of situation.

Senator ANDERSON. Sometimes Congress feels like taking a chance although all taxpayers say it is bad.

Mr. HENDERSON. I am sorry, I could not hear it, Senator.

Senator ANDERSON. I say sometimes U.S. institutions and industries take a law of this nature and find out how it works. We went through a long series of hearings on a subject very close to my heart, medicare, and all the newspapers told about how many people were going to be standing in line trying to get to the doctor on July 1st, that the hospitals were going to become jammed and that they would have to have traffic cops in the corridors. I went to a hospital that day, and there was not a soul there. Those things happen sometimes. I think this bill might be enacted and probably not very many businesses in the country would go broke.

Mr. HENDERSON. I am not sure that very many would go broke. I am sure it would help business for tax lawyers. On the other hand, I am equally sure it may well discourage business activity in the United States that now occurs here, because many, I think, sales offices may be moved out of the United States as a result of this, many licensing offices may be moved, many foreign bank operations that now occur in the United States through agencies and representatives and correspondents may change as a result of this bill.

We tried to explain in detail how this may occur. It is a policy question for the Congress to determine whether the possible problems this portion of the bill presents, which we have tried objectively to state in this report, are such that the enactment of this portion of the bill should be more thoroughly considered than it has been until now.

The CHAIRMAN. Senator McCarthy.

Senator MCCARTHY. Well, it is possible now to have a substantial operation in the United States and pay no tax at all on the profits earned, is it not? A company could manufacture in one country, sell in a second and distribute to a third, and pay no tax to any of the three.

Mr. HENDERSON. Senator, that is theoretically possible, if you can find a combination of three countries each of which has a source of income rule which so works that the company can avoid total tax. That is the reason why the bill talks about possible tax haven use in the United States.

I would like to make the following comment on that, however. First, if the United States is being used as an enormous tax haven of this kind, then I think it would be desirable to have an objective record of fact. What are the facts as to the amount of use in the United States as a tax-haven country? I would think the proponents of a provision like this ought to come up with a factual proof of the extent to which the United States is being used as a tax haven even in this fashion.

Secondly, Senator, this bill would apply even where there is no tax haven element at all. Where a taxpayer simply engages in this activity here; but pays plenty of tax abroad. There is no exception in this bill for non-tax-avoidance situations. In non-tax-avoidance situations the taxpayer would nonetheless have to go through all this complicated recordkeeping and so forth.

So if tax-haven abuse is the focus of this bill, I should think there ought to be a better factual foundation laid for the necessity of acting in that area, and, secondly, there ought to be appropriate exemptions written in the bill, as there were in subpart F, to prevent the bill from causing an undue burden where there is no tax-haven situation at all.

Now, this tax-haven problem, where the taxpayer is a foreign citizen, a foreign corporation or a foreign resident, is the reverse of the situation we dealt with in subpart F. In subpart F, the 1962 Revenue Act, we tried to avoid having foreign tax systems encourage U.S. taxpayers to export jobs and money into foreign markets because of differentials between the United States and the foreign tax rate.

Now, we solved that problem for U.S. taxpayers. If a foreign government does not care whether its citizens export jobs to the

United States and money to the United States and does not have a provision like our subpart F—or like our basic tax code which taxes the worldwide income of our citizens and resident corporations and domestic corporations—then why should the United States care? That basically is a problem of the foreign government. They have power to extend their taxing jurisdiction to their citizens, as we did in our code when we taxed all our citizens' income and as we did when we taxed certain of their income from foreign corporations under subpart F.

So this is basically not, I think, our problem. It is basically the foreign country's problem.

Senator McCARTHY. I could not completely agree to that. It would certainly give them a competitive advantage in the American market against American taxpayers. We have costs around the world which have to be paid for in some way, and the only way we have of raising money is through the imposition of taxes. So you could have all American business giving its business over to foreign firms. You say, "Don't tax them because their own country does not care."

Mr. HENDERSON. Senator, if that is happening to American firms something should be done about it.

Senator McCARTHY. Certainly it should be done. But even if it is on a small scale something should be done about it. You do not have to wait until it is 90 percent of the American market. It is an inequity. The general rule we have is that people who make money should pay taxes in this country. We are not going to get foreign countries to make a reasonable contribution to the costs which this country is now bearing around the world in defense and in economic development by imposing tribute or demanding tribute from foreign countries. That has not worked since the Roman Empire, and it did not work very well then.

The only way we can get it is by taxing foreign corporations on the basis of the business they do in this country and taxing American corporations on the basis of profits they make in foreign countries. This is the way in which you can get the revenue to pay for the worldwide expenses this country is bearing today.

Mr. HENDERSON. Senator, the basic question is will the imposition of this tax help the position of the United States.

Senator McCARTHY. Well, that is correct.

Mr. HENDERSON. If the only effect of this tax is to remove offices from the United States and force them into different countries, then I do not think we have helped the position of American business, and we certainly have not helped our balance-of-payments situation. That is a basic question of principle that ought to be examined by the Congress, and there is not enough fact in the prior record of this bill to determine whether there is any real problem here at all or whether it is just a theoretical problem, and if there is a real problem, whether this bill will solve it, or simply hurt us.

Senator McCARTHY. I have no further questions.

The CHAIRMAN. Senator Morton.

Senator MORTON. You discussed this question of a simple rule like the word "destination," which is on page 26 of your report.

Of course it is a simple one now and anybody knows destination is where the product goes. But, as you pointed out, transshipment is always possible, so destination and ultimate destination or place of consumption could be entirely different; is that not correct?

Mr. HENDERSON. Yes, sir; and that is the problem. That is difficult to determine.

As you know, this question became a very substantial issue of litigation earlier in our history under the Constitution. The Supreme Court had to deal with the original package doctrine, and all the questions presented by goods landed here for transshipment to other country or for possible transshipment.

Senator MORTON. Even more recently we have had a problem which has caused a lot of litigation in this country, the so-called Battle Act, which most of us voted for some 18 years ago here in the Congress, which brings in the question of ultimate destination.

You can ship a strategic material to France, but there is a responsibility to see that it does not go to Russia, and we have had all kinds of problems in the enforcement of the so-called Battle Act which, I think, are indicative of the problems that we might get under the language of the section of the bill to which you refer.

Certainly I think all of us want to see that the U.S. national, with a U.S. business is not unfairly—does not encounter unfair competition because a foreign national might have an office in the same building and avoid certain taxes.

But, as you say, the extent of this problem we do not know. If, in trying to cure that we throw out the baby with the bath water, and we lose business, that is here giving employment to people, to Nassau or Trinidad or wherever it might be with communication and transportation what it is today, they could easily operate in, across the border, or across the seas.

Mr. HENDERSON. That is right; and also if the main purpose were to benefit American business then it would seem essential to put this "effectively connected" concept in also where it would directly benefit an American taxpayer, to permit him to treat activities effectively connected in this sense with a foreign office as being foreign source income so he could get a foreign tax credit for it, which he cannot get under the present source rules.

Senator MORTON. You do agree that if a case can be made, American business is losing business because of a tax break that we give to a foreign operation, that this is a matter of concern to the Congress?

Mr. HENDERSON. Yes, sir.

Senator MORTON. If it can be shown.

Mr. HENDERSON. Absolutely. That is one of these major policy things that really should be fully explored, and that is all we are urging here, that this provision not be enacted until all of the facts and the issues it presents are really fully explored, and they have not been as yet.

Senator MORTON. You also agree that these features of this bill which tend to discourage the recapture by this country of foreign earnings by American companies operating abroad, in view of our balance-of-payments dilemma, that this is a matter of major concern to this committee and the Congress?

Mr. HENDERSON. It is of concern. We ought not to have provisions which artificially discourage repatriation; yes sir.

Senator MORTON. Thank you, Mr. Chairman.

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

Our next witness is Mr. Charles Bartlett of the Arizona Banking Association.

STATEMENT OF CHARLES H. BARTLETT, JR., REPRESENTING THE ARIZONA BANKERS ASSOCIATION

Mr. BARTLETT. My name is Charles H. Bartlett, Jr. I am assistant vice president and manager of the International Department of the Valley National Bank of Arizona, and I am appearing here today as a representative of the Arizona Bankers' Association.

This committee has heard testimony regarding the damaging effects of the imposition of U.S. income and estate taxes on foreign-owned deposits in banks located within the United States. Previous witnesses have stressed the balance-of-payments implications of the provisions of H.R. 13103 which would apply to those taxes, and they have explained the inconsistency between those provisions and the stated objectives of the bill.

I do not want to repeat the positions that have already been presented to the committee, but there are a few points that are of importance to banks in my State and to others similarly located along an international boundary line. The same factors apply, though perhaps to a less extent, to banks in other interior points whose volume of foreign business is not on the scale enjoyed by banks in our larger financial centers, but is nevertheless of importance to themselves.

The amount of deposits attracted by Arizona banks from foreign corporations is quite limited. For the most part, our foreign deposits come from individuals who are attracted by this country's record of political stability and very excellent reputation for preserving the value of money in comparison with that of most other parts of the world. Higher after-tax yields can be obtained in many other countries.

But there is a limit to the price foreigners will pay to keep money in our country. This year, we have noticed a loss of deposits to other countries because of their higher interest rates. If to this we add a 30-percent tax rate, there can be no question but that the flow of money to other countries would be accelerated. Many countries with favorable political climates now have strong financial institutions which actively solicit U.S. dollar deposits. It is interesting to note that foreign depositors who transfer money out of the United States for the most part do not repatriate it to their own countries, but rather place it where they can best attain their deposit objectives.

The imposition of income taxes will most definitely cause the loss of important deposits by the banks in Arizona. Contrary to the House report, the effect will be noticed immediately and not in 1971. Anyone who has himself wrestled with the intricacies of our own tax laws can appreciate the problems in trying to explain them to people living perhaps hundreds or even thousands of miles away.

I know of no more frustrating experience than trying to explain a point of law or taxation on the telephone in a foreign language to a person not familiar with our legal concepts. I recently tried unsuccessfully to translate into verbal Spanish the new Federal Reserve regulations on multiple maturity time deposits, and, I am sure, that would be rather simple compared to what H.R. 13103 would require. We can be sure that the new tax measures would be given wide publicity and the mere fact of taxability, once brought to the attention of our foreign customers, would cause an immediate outflow of funds. Some bankers report it has already started. Our banker friends abroad are strong competitors, and know how to make good use of any advantages they have.

There really can't be much doubt about what an income tax would do to foreign-owned deposits; but an estate tax would be absolutely deadly. I don't think any conscientious banker could fail to acquaint his foreign customers with the imposition of an estate tax. The bank I work for would most definitely do so.

In this context, it should be remembered that some countries do not have any estate or inheritance taxes whatsoever. Certainly, people in those countries cannot be expected to invite loss of even a small part of their capital by leaving their funds in the United States. We have certain attractions, as I mentioned, but our margin of advantages is not as wide as it was 20 years ago. It does not permit us to impose a charge for safekeeping.

This bill will effectively destroy a very major share of the deposits which enable the banks in my State to support international departments. None of us have foreign branches or subsidiaries and, while our foreign business is growing, we do not have the volume of transactions which would normally be required to serve as the bases for foreign operations of one type or another. The enactment of H.R. 13103 in its present form would force important deposits to move to foreign banks and foreign branches of other American banks. The growth of our foreign banking activities would be dealt a blow from which it would take us many years to recover. We would be at a competitive disadvantage both at home and abroad.

The Arizona Bankers Association urges the elimination from H.R. 13103 of those provisions which would subject foreign-owned deposits to income and estate taxes.

The CHAIRMAN. Thank you very much.

Mr. BARTLETT. Thank you, gentlemen.

The CHAIRMAN. Senator Anderson.

Senator ANDERSON. The Valley Bank has a number of branches in the State of Arizona, does it not?

Mr. BARTLETT. Yes, sir.

Senator ANDERSON. And the First National Bank also has?

Mr. BARTLETT. Yes, sir.

Senator ANDERSON. Both of these banks feel this is a dangerous piece of legislation?

Mr. BARTLETT. Yes, sir.

Senator ANDERSON. I only want to testify that these are two very fine and highly respected institutions and very well regarded in the Southwest.

Mr. BARTLETT. We feel every bit as strong as Mr. Young in El Paso.

The CHAIRMAN. Thank you very much, sir. I think your views are very precise.

Senator MCCARTHY. I have no questions unless he has some views on the other provisions of the bill which he would like to express. You are concerned only with the interest?

Mr. BARTLETT. Those are the two points I am here to represent my State association on, Senator, yes.

The CHAIRMAN. Thank you.

Next is Mr. A. Richard Finchell of the Greater Miami Savings Center.

STATEMENT OF A. RICHARD FINCHELL, PRESIDENT, GREATER MIAMI SAVINGS CENTER

Mr. FINCHELL. Good morning, Senators Long, McCarthy, Anderson, and Morton. I come here as president of the savings and brokerage firm called Greater Miami Savings Center, and also president of a direct-mail advertising company which serves as a coordinator of overseas direct mail advertising for deposits by a group of 25 insured savings and loan associations of Californio.

My attorney has filed with Chairman Long a letter dated August 8, in which he sets out the technical points to House bill 13103 which we feel are objectionable, despite the purposes of the act, and which would be injurious, we believe, to more than 99 percent of the U.S. commercial banks, the entire mutual savings bank industry, and the entire U.S. savings and loan industry.

The CHAIRMAN. We will print the whole statement in the record. You can read it if you want to, or summarize it.

Mr. FINCHELL. No. If you do not mind, Senator, I would prefer to make just a few points of a background nature of my experience in the business which you may find helpful, which are not included in my attorney's submission.

The CHAIRMAN. As you know, you can sit here in this room and hear some of these points made two or three times. What we are especially interested in is what you can add to it because I notice——

Mr. FINCHELL. Yes.

The CHAIRMAN. I notice you object to this House amendment just as the previous witness did. Do you think it would tend to run foreign deposits out of American banks?

Mr. FINCHELL. The only point I think would be novel to you and, possibly of interest to you, would be how it would affect, presently affect, the U.S. savings and loan industry. I do not think that voice has been heard yet.

The CHAIRMAN. Yes.

Mr. FINCHELL. And the nature of the depositors who would be driven out or would be discouraged from bringing their money into the United States.

In 1958, the Internal Revenue Service ruled that interest-paying savings and loan associations rather than mutual-type savings and loan associations were, for the purposes of the Internal Revenue regulations or the statutes governing interest paid to foreigners, persons carrying on the banking business in the United States and, therefore, the exemptions from interest on estate tax were extended to depositors or savings account holders with certain types of savings and loan associations primarily located in California and Ohio, State-chartered institutions, most of them federally insured.

This extension of the exemption was extended 4 years prior to 1958 to the entire mutual savings bank industry in the United States.

So, in effect, what you have today is not only deposits that would possibly be driven out of the United States if this bill were enacted as proposed, but also from mutual savings banks and from savings and loan associations.

Since 1958 we have forwarded close to $80 million foreign savings deposits to California savings and loan associations where foreigners have enjoyed exemption from U.S. income tax and U.S. estate tax, and most of these people are middle-class people, they are people who would, for the most part, not know how to go about establishing a foreign-situs corporation to avoid the U.S. estate tax.

These are middle-class people engaged in commerce primarily with the United States and they find it expedient and desirable for their own peace of mind to keep a part of their earnings from the United States in the United States in the form of savings deposits, all of which are insured by permanent agencies of the U.S. Government, because these are little people depositing $10,000 in a number of savings institutions.

I would estimate that there are a quarter of a billion dollars on deposit in California savings and loan associations today by foreigners who are enjoying these tax exemptions, exemptions from income and estate tax, and although I do not have any figures either on the New York mutual savings banks in particular, I would estimate that approximately a like amount is on deposit in mutual savings banks in the United States. In other words, approximately half a billion of foreign deposits in the United States are presently with tax-exempt savings banks and savings and loan associations.

I will not go into the—I think it is needless at this late stage to go into the reasons why this money would be driven out of the country. I think it has been amply and eloquently explained.

I think it is also worthy of note that the average individual who has deposits in the United States, a foreigner, from my experience, probably has a checking account, certificates of deposit and savings account approximately of $50,000, so that he would be consuming his $30,000 estate tax exemption immediately, and this would not take into account any equity investment that he had in the United States.

There is a discriminatory feature in this bill which I am sure also has been brought to your attention, that effective immediately with January 1, 1967, only deposits by foreigners in foreign branches of U.S. commercial banks would be exempt from the U.S. estate tax, and after 1971, only those branches of U.S. banks abroad could offer foreigners exemption from U.S. income tax.

There are two points I think the committee should take into account on why this discrimination should not hold in the final bill and that is, No. 1, if all the foreign deposits presently in the United States gravitate to these foreign branches, there would be so much money going to these foreign branches that the interest they pay to a foreigner may not be sufficient to hold all the money that had been exited from the United States and would be going back onto other investments in other countries.

The CHAIRMAN. We have been complaining about tight money in the United States, and that would make it a lot tighter because that would be pulled out from investment here.

Mr. FINCHELL. Yes.

Senator McCARTHY. Did you say you ran a direct-mail appeal?

Mr. FINCHELL. Yes.

Senator McCARTHY. What is the nature of that?

Mr. FINCHELL. It is a group of 25 California savings and loan associations as a group advertising by direct mail abroad.

Senator McCARTHY. Which countries, primarily? Europe?

Mr. FINCHELL. Europe, Latin America, the Middle East, and other areas of the world where there has been an outflow, to which there has been a heavy outflow, of all U.S. money. In effect, we are trying to bring it back, and that is the easiest type of money to bring back into the United States.

Senator McCARTHY. Do you emphasize the fact that their interest earnings are not taxable?

Mr. FINCHELL. Oh, yes; it is one of the prime attractions to a foreigner, which is the interest and estate exemption.

Senator McCARTHY. And estate tax.

Mr. FINCHELL. Definitely, sir.

The CHAIRMAN. So what you have been doing is advertising that you have a good deal here for foreigners to invest money in the United States. You had been attracting quite a bit of U.S. dollars back into American investment, and then here comes a bill which originally is intended to encourage foreigners to bring this money in, but by the time you see a House amendment you are convinced that the money will be flowing out instead of in, as far as you are concerned.

Mr. FINCHELL. Yes; a crazy quilt.

The CHAIRMAN. One of the Senators who sat through the first 2 days of hearings told me yesterday that he was firmly convinced this bill started out as a bill to attract foreign investments over here, and by the time it came from the House they would run more dollars out of here than they would bring in. I think your statement is one more piece of evidence along that line.

Mr. FINCHELL. There is one final point I would like to make. This bill extended the tax exemptions or at least the interest tax exemptions to 4,400 other savings and loan associations in the United States of a mutual nature, including savings and loan associations in Minnesota, New Mexico, Louisiana, and Kentucky, which are of the mutual type or semimutual type. But there is wording in that extension which makes it very difficult, which will make it very difficult, for the savings managers of these institutions to properly tell the story to the foreign investor because it states that only savings institutions which meet a certain section, and it is rather obscure for a foreigner, and it is the recommendation of my attorney as well as ourselves that an easier identification be made as to what type of savings institution does qualify, and I think that the most simple one would be an institution whose accounts were insured by either the FDIC or the FSLIC.

Senator ANDERSON. That would take them all, would it not?

Mr. FINCHELL. Yes. That would take virtually all of them.

The CHAIRMAN. Thank you very much.

Mr. FINCHELL. Thank you, sir.

(The letter dated August 8, 1966, referred to above, follows:)

STONE, BITTEL, AND LANGER,
Miami, Fla., August 8, 1966.

Re hearings on H.R. 13103.

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

DEAR MR. CHAIRMAN: Some of the provisions of the proposed *Foreign Investors Tax Act of 1966* (H.R. 13103) are inconsistent with President Johnson's balance-of-payments program. These provisions deal with the taxation of deposits by foreign investors in U.S. banks and savings institutions. As presently written, they are likely to drive away existing funds now on deposit in the U.S. and to discourage foreign investors from making new deposits.

The Bill would broaden the income tax exemption granted foreign investors on their deposits in U.S. savings institutions by increasing the number of institutions whose interest payments are income tax-free. The exemption would now apply to dividends and interest paid on accounts in virtually all savings and loan associations. In the past it applied only to earnings paid by a limited number of such associations.

However, the Bill eliminates, effective immediately upon enactment, the estate tax exemption which has historically been accorded to such deposits.

We have several overseas clients who maintain substantial amounts on deposit in U.S. savings institutions. Often, in making deposits totaling hundreds of thousands of dollars, they deposit only $10,000 each in numerous different savings institutions so as to make certain that all such deposits are fully insured by either the FDIC or FSLIC. We believe that many of such deposits will be withdrawn if they might become subject to a potential U.S. estate tax. Many foreign investors will not be willing to keep money on deposit in the U.S. in the face of an estate tax which will take from one to five times the amount of the annual earnings from such deposits.

It is not likely that substantial revenue can be raised by such a provision. A knowing investor could legally avoid the estate tax on such deposits by making them through a foreign corporation whose shares would not have a U.S. situs for estate tax purposes.

We believe that consideration should be given by the Congress to the following suggested changes in the Bill:

1. The estate tax exemption for deposits by foreign investors in U.S. savings institutions should be continued concurrently with the income tax exemption. Thus, if the income tax exemption expires in 1972, the estate tax exemption should expire at the same time.

2. The estate tax exemption, as in the past, should cover all deposits and accounts in banks and savings institutions which will be covered by the income tax exemption.

3. The scheduled elimination in 1972 of the income tax exemption for deposits by foreign investors in U.S. savings institutions appears unwarranted. This exemption has been in force for 45 years, since the Revenue Act of 1921. It was enacted in the first place to discourage foreigners from withdrawing their bank deposits from the U.S. Such a goal is even more important now than it was then. The proposed elimination of such exemption is therefore directly contrary to the avowed purpose of this Bill, which is to remove tax barriers to foreign investment in the U.S. Moreover, it represents a premature guess that the U.S. balance-of-payments problem will have been completely solved by 1972. Many foreign investors may begin pulling out their deposits long before the scheduled termination date rather than worry about keeping track of the situation. Even if the Congress feels inclined to remove this exemption in 1972, we believe it should wait until at or near that time to take such action.

4. The present version of the Bill would give a monopoly with respect to bank deposits and savings accounts to those few U.S. banks with overseas branches. Interest paid to foreign investors on deposits in a foreign branch of a U.S. bank would be exempt from income tax even after 1971. Moreover, the foreign investor could get tax-free interest from a foreign branch of a U.S. bank whether or not such interest is effectively connected with the conduct of

a U.S. trade or business. Thus, beginning in 1972, a foreign investor can either get tax-free interest from a foreign branch of one of the few large U.S. banks operating overseas or fully taxable interest from any of the many thousands of other domestic banks and savings and loan associations.

An earlier version of the Bill would have allowed this exemption only to *foreign currency* deposits in foreign branches of U.S. banks. Although foreign currency deposits would be less likely to compete with U.S. Dollar deposits in domestic banks and savings institutions, such a limitation would not materially improve the situation. The limitation could be avoided too easily by a foreign investor making his deposits in a foreign branch of a U.S. bank in some foreign currency which is closely tied to the U.S. Dollar. It is even possible that the amount payable by the bank could be tied to the U.S. Dollar by insurance or hedging transactions. Thus, such a rule would also unduly favor those few U.S. banks having foreign branches. While the provision would undoubtedly strengthen the competitive position of those U.S. banks having foreign branches as against foreign banks, it would also unduly strengthen their competitive position as against all other domestic banks and savings institutions.

5. The Bill provides that for estate tax purposes, hereafter only a deposit with a foreign branch of a U.S. bank will be deemed non-U.S. property. A decedent nonresident alien will be exempt from U.S. estate tax on such a deposit whether or not he was engaged in business in the U.S. at the time of his death. Thus, the Bill would further favor the few U.S. banks having foreign branches in two additional ways. It would immediately remove the existing estate tax exemption accorded deposits by foreign investors in all other domestic banks and some other savings institutions. In addition, the exemption to be continued only for deposits in foreign branches of U.S. banks would be permitted whether or not the foreign investor was engaged in business in the U.S. at the time of his death.

This immediate withdrawal of the estate tax exemption now accorded most deposits by foreign investors in domestic banks and savings institutions may well prove disastrous to the President's balance-of-payments program. The money pulled out in fear of the potential estate tax will go to foreign banks and to the foreign branches of U.S. banks. In either case, it will no longer be subject to the guidelines limiting lending abroad and similar restrictions designed to improve our balance-of-payments situation. Most of such funds will no longer be a part of the U.S. economy.

6. A foreign investor cannot reasonably be expected to determine the income tax status of the U.S. savings institutions in which he deposits his money in order to determine his own tax status. Therefore, we suggest elimination of the words (page 5 of the Bill, lines 13–16):

"* * * but only to the extent that amounts paid or credited on such deposits or accounts are deductible under section 591 in computing the taxable income of such institutions, * * *".

It is probably sufficient to require that the association be "chartered and supervised". If a further limitation is deemed necessary, it should be one which the foreign investor can more readily determine, for example, a requirement that the association be insured by either the FSLIC or FDIC.

We appreciate the opportunity of presenting these views on H.R. 13103 and we request that this letter be made a part of the record of the hearings on the Bill.

Sincerely yours,

MARSHALL J. LANGER.

(By direction of the Chair, the following letter is made a part of the record at this point:)

NATIONAL LEAGUE OF INSURED SAVINGS ASSOCIATION,
Washington, D.C., August 8, 1966.

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

DEAR MR. CHAIRMAN: It is respectfully requested that this letter be included in the record of the hearings on H.R. 13103, the Foreign Investors Tax Act of 1966.

The National League of Insured Savings Association is a nationwide trade association representing savings and loan associations having accounts insured by the Federal Savings and Loan Insurance Corporation. Our membership consists of some members having a permanent stock form of organization and others having a mutual form of organization.

Under current rulings of the Internal Revenue Service, it is our understanding that the income on all mutual and some stock savings and loan association savings accounts held by non-resident aliens not engaged in business in the United States is subject to Federal income, withholding and estate taxes. Such aliens who hold like accounts in other domestic stock savings and loan associations are not subject to these taxes under current IRS interpretations.

With reservations as noted, the National League supports the following provisions in H.R. 13103 that pertain to this problem.

Income Tax. Section 2(a)(1)(A) would amend Section 861 of the Internal Revenue Code to provide that there be excluded from the category of income from sources in the United States "interest" on deposits or withdrawable accounts in savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law, to the extent the amounts paid or credited are deductible under Section 591 of the Internal Revenue Code in computing taxable income of the savings institution. The exclusion would cease to apply to amounts paid or credited after December 31, 1971.

These provisions would remove the present difference in tax treatment given earnings distributed to savers in some stock savings and loan associations, when compared with other stock savings and loan associations and all mutual savings and loan associations, as long as the word "interest" continues to have a broad enough connotation to include dividends or similar distribution of earnings on a savings account in a savings and loan association, as it has under current law. Naturally the savings and loan industry would prefer that the exemption be continued beyond 1971, in order to hold and attract more savings from non-resident aliens not engaged in business with the United States. It appears to us that this would help to increase foreign investment in the United States.

Withholding Tax. It is our understanding that until the end of 1971, the bill would require no withholding of tax by virtue of interest received by a non-resident alien from a savings account in a savings and loan association located in the United States.

Section 3(g) amending section 1411 of the Internal Revenue Code would still appear to exempt any need for withholding any tax on income that does not constitute gross income from sources within the United States.

Section 3(i) proposes to amend section 6105 of the Internal Revenue Code by adding a new subsection (i) to the effect that no declaration of estimated tax would be required from a non-resident alien for income not effectively connected with the conduct of a trade or business in the United States (other than a resident of Puerto Rico). Section 2(d) would amend section 864 of the Internal Revenue Code by adding a paragraph (c)(4) headed Income From Sources Without United States which provides, among other things, that no income from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States, except for situations outlined that would not normally apply to income received from a savings account in a domestic thrift institution. As previously noted, until the end of 1971, Section 2(a)(1)(A) of the bill would not include dividends from savings accounts in savings institutions in the category of income from sources *within* the United States.

Estate Tax. It is our understanding that section 8(e) of H.R. 13103 would increase to $30,000 from $2,000 the exemption from gross estate of a non-resident alien. This would encourage an individual non-resident to place savings with thrift institutions in the United States as well as investing in other media to the total amount of $30,000, without incurring a Federal estate tax, and hence is preferable to a flat $2,000 exemption. Again, of course, the potential estate tax liability for estate in excess of the $30,000 per taxpayer would serve as a deterrent to the investment of more than that amount in the United States by a non-resident alien individual. But the provision does avoid any problem of distinction based on whether the investment is held in a particular type of savings and loan association and in that regard, is deserving of our support.

Conclusion. If our interpretations of the effect of the provisions above noted (dealing with income tax liability, withholding tax liability, and estate tax liability) agree with that of the Committee, the National League supports the provisions insofar as they treat all domestic savings and loan associations alike. As noted, it is hoped the Committee will give further consideration to the limitations of time and amount above noted in weighing whether a liberalization would be desirable in the public interest in order to attract more investment funds to the United States.

Sincerely,

WILLIAM F. MCKENNA,
General Counsel.

The CHAIRMAN. That concludes the hearings on the bill. I have announced that we will hold some hearings on proposed amendments that will be offered to the bill, such as the amendment relating to campaign contributions. So I would hope we could study what we have here—Senator Williams had planned to offer an amendment and I had promised hearings on the subject, and I thought we ought to hold them before we voted on the bill. The committee will print as part of the hearings a number of communications received from parties. Particularly, the published hearings should contain the several letters received from gentlemen who served as members of the Presidential task force along with Secretary Fowler, the task force whose recommendations prompted legislation along the lines of this bill.

(The letters referred to follow:)

MORGAN STANLEY & CO.,
New York, N.Y., August 5, 1966.

Re Foreign Investors Tax Act (H.R. 13103).

Hon. Senator RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: Morgan Stanley & Co. has followed with considerable interest the actions taken by both the private and public sectors which would have an effect on the United States Balance of Payments. Our partner, John M. Young, was a member of the Fowler Task Force, and since the recommendations of this Task Force were given to President Johnson we have been particularly interested in supporting measures which would implement these recommendations. We are therefore writing to respectfully urge you and your Committee to give favorable consideration to the Foreign Investors Tax Act, which we understand will be before your Committee next week.

Although this Bill in its present form implements many of the recommendations of the Task Force, it is our understanding that H.R. 13103 still contains provisions which will continue the imposition of estate taxes on holdings of U.S. securities by foreigners, although at a reduced rate, and in addition imposes new taxes on other forms of investment, including U.S. bank deposits, which will make investment in the U.S. even less attractive to foreign investors. It was the opinion of the Task Force that the estate tax on foreign holdings of U.S. securities has been one of the primary deterrents to investment by foreigners in this country, and should therefore be eliminated. The elimination of this tax would seem even more appropriate in view of the fact that this area of taxation is expected to produce annual revenue of less than $5 million.

Implementation of the Task Force recommendations is long overdue, and we therefore urge you and your Committee to expedite passage of the Bill, at the same time taking the necessary action to correct those provisions of the Bill which impose taxation which will adversely affect foreign investment in the United States and thus further impede improvement in our Balance of Payments.

We are enclosing additional copies of this letter for the members of the Committee.

Respectfully yours,

MORGAN STANLEY & CO.

Enclosure.

TWENTY EXCHANGE PLACE,
New York, N.Y., August 3, 1966.

Re Foreign Investors Tax Act (H.R. 13103).

Hon. Senator RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: As the member of the Fowler Task Force most heavily concerned with the preparation of its tax recommendations, I urge your favorable consideration of the Foreign Investors Tax Act.

With the exception of its recommendations in respect of estate taxes, the Act, in general, carries out the recommendations of the Task Force.

In certain respects, the Act goes beyond these recommendations in that it incorporates new provisions, which I am informed, might constitute a deterrent to foreign investment and result in an adverse effect upon our balance of payments. Among these are:

1. the provision for the withholding of taxes on interest paid on bank deposits; and

2. the provision which would impose U.S. income taxes on foreign source income of foreign corporations and individuals under certain circumstances.

I will not go into the reasons for these conclusions as they undoubtedly will be advanced before your Committee by others more familiar with the problems.

The recommendation of the Task Force for elimination of all estate taxes on foreign holdings of securities was considered to be one of its most important recommendations.

The bill as passed by the House not only continues the imposition of a tax, although at a reduced rate, on securities presently subject to tax, but imposes new taxes on certain other securities and, more particularly, on U.S. bank deposits.

The report of the Committee on Ways and Means would indicate that the total revenue involved in these various estate tax provisions is in the neighborhood of 2 to 5 million dollars. If the Task Force is correct in its judgment, the adverse effect upon the balance of payments of these estate tax provisions would have far greater significance.

Although I have not had an opportunity to determine the views of the members of the Task Force with respect to the Act, I believe that they would not be inconsistent with the foregoing. I, therefore, respectfully recommend that the Act be approved with the exceptions referred to above.

Respectfully yours,

FREDERICK M. EATON.

MOBIL OIL CORP.,
NEW YORK, N.Y., *August 5, 1966.*

Re Foreign Investors Tax Act.

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

DEAR MR. CHAIRMAN: As as member of the Fowler Task Force on "Promoting Increased Foreign Investment and Increased Foreign Financing", I have been following with interest the progress of the Foreign Investors Tax Act, now pending before your Committee as H.R. 13103.

This measure was originally introduced in March 1965 as H.R. 5916. As then introduced, it would have substantially though not completely implemented the tax recommendations of the Task Force.

At the end of September 1965, H.R. 11297 was introduced as a modified version of H.R. 5916. Two modifications, a provision for the inclusion of U.S. bank deposits owned by non-resident alien decedents not engaged in trade or business in the United States in the U.S. estates of such aliens dying after the enactment of the Bill and a provision which after five years would subject interest on U.S. bank deposits of non-resident aliens or foreign corporations to U.S. income tax, work directly against the basic objective of improving U.S. Balance of Payments through increased foreign investment in the United States. These provisions are still included in the present version of the Bill, H.R. 13103; in my opinion they should be eliminated.

A third important change would have subjected foreign corporations and non-resident aliens engaged in trade or business in the United States to U.S. income tax on their world-wide income (not restricted to U.S. sources) "effectively connected" with the United States trade or business. This highly objectionable section was greatly modified and improved by the present provisions of H.R. 13103. There remain, however, certain problems under the "effectively connected" concept, including an apparently unintended upstream dividend tax on certain distributions of foreign corporations to U.S. shareholder corporations. I understand that these problems and possible amendments to meet them have been presented to you or will be developed by technical witnesses before your Committee.

The Foreign Investors Tax Act will provide a significant aid to the improvement of our national Balance of Payments. In my opinion, therefore, the measure is in the national interest and should be enacted, but hopefully with the changes suggested above.

Respectfully yours,

GEORGE F. JAMES.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,
August 9, 1966.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
U.S. Senate, Senate Office Building,
Washington, D.C.

DEAR SIR: As a member of the Task Force appointed by the late President Kennedy to investigate ways of promoting increased foreign investment in United States securities, I would like to recommend prompt and favorable consideration of the Foreign Investors Tax Act of 1966 (H.R. 13103), which I understand is now before your Committee.

Amendment of the tax inequities with respect to foreign investors was one of the several important recommendations made by the Task Force. The Foreign Investors Tax Act of 1966, in general, incorporates the recommendations of the Task Force and remedies and corrects many of these tax inequities.

The Act, in its present form, however, contains certain provisions which, in my opinion, might well serve as deterrents rather than inducements to foreign investment. I refer, among others, to the provisions regarding the imposition of estate taxes, albeit at a reduced rate, on foreign holdings of securities, the withholding of taxes on interest paid on bank deposits, and the imposition of United States income taxes on income which is "effectively connected" with the conduct of a trade or business in the United States. I do not intend to dwell upon these items, as I am certain they will receive detailed and thoughtful examination by you and your Committee.

Not withstanding the foregoing, I feel that the Foreign Investors Tax Act of 1966 is a positive step towards righting the tax inequities in our present laws and with the reservations noted above I strongly urge its approval and endorsement.

Respectfully yours,

GEORGE J. LENESS.

The CHAIRMAN. That concludes the hearing on this part.

(Whereupon, at 12:10 p.m., the committee adjourned.)

(By direction of the chairman, the following communications are made a part of the record:)

STATEMENT OF RALPH YARBOROUGH

Mr. Chairman and members of the Senate Committee on Finance, I appreciate the privilege of submitting testimony to this distinguished committee.

I wish today to submit my views on H.R. 13103, the Foreign Investors Tax Act of 1966. In particular, I wish to direct the committee's attention to a provision in the bill which would impose a U.S. income tax on interest paid by U.S. banks to nonresident aliens on time deposits held in U.S. banks.

This provision was added by the House Committee on Ways and Means. It was not included in the original administration proposal. Nor was it a part of the report of the Fowler Task Force, which was the basis for the bill. I understand that the administration has taken no position on the provision. It is opposed by the American Bankers Association and by bankers in my State.

In an effort to arrive at an estimate of the effect of the bill, I wrote Mr. Stanley S. Surrey, Assistant Secretary of the Treasury, on August 2, 1966, asking for the amount of the deposits which would be affected, the amount of deposits that would be withdrawn if the provision were enacted, and the additional revenue that would be generated by enactment.

Mr. Surrey replied that the total amount of time deposits covered is approximately $2,250 million.

In reply to my second question Mr. Surrey replied that "We do not feel that we are in a position to give you any such estimate because of the uncertainty as to the reaction which foreigners may have to such tax and the fact that a large number of bank deposits are held as working balances by corporations which do not bear interest and hence would not be affected by the bill."

In response to the third question Mr. Surrey replied that, making numerous assumptions, a rough estimate of the total revenue which would be derived from taxing the interest would be $22,500,000. However, inasmuch as one of the assumptions he made was that foreigners' time deposits held in 1972 (the date when the provision would go into effect) would be equal to those held by them today, and he had already stated that the effect on foreigners' holdings of time deposits was unknown, this estimate would appear to be of little reliability.

Let us, then, examine what we know. We know that the amount of deposits affected totals $2,250 million. But we do not know how much additional revenue would be generated, nor how many dollars worth of deposits would be withdrawn. It would seem, then, that we are legislating in the dark.

We can speculate on human nature, however. It is obvious that if a country suddenly imposes an income tax on the interest received by someone who is neither a citizen nor a resident of that country, he is going to look for another place to put his money. So we can most surely assume that there will be large-scale withdrawals of funds. At a time when we are still in a period of difficulty over our balance of payments, it is unwise to look for new troubles in this regard. This money from foreign countries on deposit in American banks is used in America; this capital helps relieve our money shortage. Its withdrawal would worsen our tight money problems. In my opinion, it is fiscally unsound to drive this money out of the country. Many other countries would welcome these deposits within their boundaries.

As a Senator from Texas I have a concern for the welfare of all the people in the communities of my State. This bill would hurt not only bankers, it would hurt everyone in the community, because the banks would have less money to loan and the economic activity of the community would thus be diminished. One bank in my State indicates that one-fourth of its deposits of $40 million would be affected. At a time when interest rates are high because of a shortage of loanable funds, this is no time to diminish loan funds still further.

I respectfully suggest to the committee that since we have so little hard evidence as to the effects of the change, and since commonsense would seem to indicate that funds would probably be withdrawn in large amounts, that we are running a risk of enacting a law which will raise only a little extra revenue and scare away large amounts of funds. The purpose of the Fowler Task Force was to study ways of increasing foreign investment in the United States. This seems a peculiar way to do it.

For these reasons I urge the committee to delete this section from the House-passed bill.

I ask unanimous consent that the letter to me of August 9 from Assistant Secretary of the Treasury, Stanley S. Surrey, be printed at the conclusion of my remarks.

TREASURY DEPARTMENT,
Washington, D.C., August 9, 1966.

Hon. RALPH YARBOROUGH,
U.S. Senate,
Washington, D.C.

DEAR SENATOR YARBOROUGH: This is in reply to your letter of August 2, 1966, requesting information concerning the effect of those provisions in H.R. 13103 dealing with the taxation of bank deposits of foreigners in the United States.

You first ask the amount of deposits which would be affected by these provisions in the United States and in Texas. Unfortunately, we do not have figures available on a State-by-State basis, and consequently we cannot give you any information on the amount of such deposits in the State of Texas. In the United States as whole there are total bank deposits to foreigners of approximately $9½ billion. Of this total, only those which are time deposits, $2.5 billion, and which bear interest would be affected by the provision in H.R. 13103 taxing such interest. In addition, deposits of foreigners who are residents in certain countries with which we have a tax treaty exempting interest would not be affected. As a result, the total number of time deposits on which interest subject to tax would be paid is approximately $2.240 million.

The estate tax would only be levied on deposits held by individuals. Unfortunately, our figures do not discriminate between deposits of individuals and private companies other than commercial banks, and consequently we are not in a position to give you any figures as to the amounts of such deposits which would be affected by the estate tax provisions of H.R. 13103, though of course it would only be a small part of the total deposits.

Your second question relates to the anticipated change in the amount of such deposits that would be brought about by the enactment of H.R. 13103 in its present form. We do not feel that we are in a position to give you any such estimate because of the uncertainty as to the reaction which foreigners may have to such tax and the fact that a large number of bank deposits are held as working balances by corporations which do not bear interest and hence would not be affected by the bill. It was our feeling when the Ways and Means Committee considered the matter that the bill would not have a substantial current impact in view of the postponement until 1972 of tax on the interest on these deposits.

Your third question asked the additional revenues that would result from passage of the act. As indicated above, we are not in any position to estimate the estate tax revenues which might result if the bill were passed though the figure is not a large one. In 1963, our figures indicate that estates of nonresident aliens filed estate tax returns showing a total of less than $5 million in U.S. bank deposits. However, some aliens whose only U.S. assets were bank deposits which were exempt from estate tax may not have filed a return.

Any estimate of the income tax which might result from the imposition of this tax must necessarily be based on numerous assumptions. These assumptions include the amount of time deposits which would be held by foreigners in 1972 when the tax went into effect, the interest rate that would then be paid on such deposits, and the rate of tax which would be levied on such income. At the present time, our statutory rate of withholding tax is 30 percent, but this is modified in many cases by treaty. If it is assumed that foreigners' time deposits in 1972 were to equal those held by them today, that the interest rate on such deposits is 4 percent, and that the same percentage of such deposits are held by foreigners subject to reduced rates of tax by reason of our tax treaties, the total revenue which would be derived from taxing such interest would be approximately $22,500,000.

We trust that this answers your questions.

Sincerely yours,

STANLEY S. SURREY,
Assistant Secretary.

STATEMENT OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK, SUBMITTED BY LAWRENCE F. CASEY, CHAIRMAN, COMMITTEE ON TAXATION

SECTION 2(d). DETERMINATION OF INCOME "EFFECTIVELY CONNECTED" WITH A UNITED STATES TRADE OR BUSINESS

H.R. 13103 would bring about two important new Federal income tax consequences affecting the income of nonresident aliens and foreign corporations:

First, certain income from sources without the United States would, for the first time, be subjected to United States taxation.

Second, the traditional "force of attraction" of a trade or business conducted by a nonresident alien or a foreign corporation in the United States, resulting in the taxation of nonbusiness as well as business income from United States sources at regular rates—meaning progressive rates for individuals and regular corporate rates for corporations—would no longer apply. Nonbusiness, or "passive," income would be subject, instead, to a flat 30% rate of tax (or a lower treaty rate if applicable).

H.R. 13103 would accomplish both foregoing results by introducing into the Code a new concept, derived from recent income tax conventions—that of "income effectively connected with the conduct of a trade or business within the United States."

This Committee strongly urges that the first of these effects—erosion of the traditional limitation of United States income tax to income from United States sources in the case of a nonresident alien or a foreign corporation—be eliminated from H.R. 13103. This Committee concurs in the elimination of the "force of attraction" doctrine as it affects passive income from United States sources.

A. Income from sources without the United States

One of the stated purposes of the original Foreign Investors Tax Bill was to promote and encourage investments in the United States. The adoption of a rule taxing non-United States source income is at cross-purposes with this purpose.

The Bill would introduce into the Internal Revenue Code complexities which would seem to outweigh any additional revenue which the concept might produce.[1]

[1] We note that the Report of the Ways and Means Committee does not in its estimate of the revenue effects of the Bill reflect any increase of revenues due to the introduction of these particular provisions.

These complexities will discourage foreign businessmen who are considering engaging in business here because it will make it more difficult for them to determine the extent to which they will be subject to United States tax. Moreover, we question the desirability of a legislative provision whose real purposes and effects are completely unclear without the extensive exegesis contained in the Committee Report.

Some of the ambiguities present can be seen if we examine the Bill's treatment of sales of personal property outside the United States—proposed section 864(c)(4)(B)(iii). Income "attributable" to an "office or fixed place of business" in the United States derived from the sale outside the United States of personal property will be subject to tax in the United States. The term "office or fixed place of business" has been the subject of litigation in the past. The Committee Report uses the terms "relatively sporadic and infrequent," "merely," "on occasion" and "absent other circumstances" (Report, p. 63) in explaining the intended meaning of the term. The term "attributable" is itself obviously vague and the Report does little to remedy this by stating that income will be attributable to the United States office if that office is the "primary place" (Report p. 19) of activity giving rise to the sale. An exception is made to this rule if the property is sold for "use, disposition or consumption outside the United States" and an office or other fixed place of business of the taxpayer outside the United States makes a "material" contribution to the sale. What is a "material" contribution? Each of the terms quoted in this paragraph will require interpretation over many years before its meaning is known. We submit that the creation of this much ambiguity and complexity is hardly calculated to encourage foreign persons to engage in business in the United States.

Many examples of undesirable results arising under proposed section 864(c)(4)(B) might be given. For present purposes, one example will be noted with respect to each of the three categories of foreign source income which H.R. 13103 would subject to the United States tax.

(i) Rental or royalty income.—Assume that a foreign-owned Dutch corporation develops know-how and patents in Holland and licenses rights thereto in Mexico. The Dutch corporation has a United States office which participates in the negotiation of licenses of such know-how and patent rights. Under H.R. 13103 the United States would claim tax upon all royalties paid from Mexico to the Dutch corporation. One alternative open to the Dutch corporation quite obviously would be to abandon its office within the United States and locate its licensing activities exclusively outside of the United States.

(ii) Dividends, interest, gains or losses.—Assume that a foreign underwriter has a New York office and participates in an underwriting of the securities of a United States corporation. Under proposed Section 864(c)(4)(B)(ii) it would seem that underwriter income arising from the sale of such securities by the foreign underwriter outside the United States would be fully subject to taxation in the United States.

(iii) Income from sales of personal property.—Assume that a foreign-owned Canadian corporation manufactures a chemical in Canada for sale to European markets. The company establishes a sales office in New York City from which point it solicits and negotiates sales of the chemical. The Canadian manufacturing plant is the sole supplier of the chemical, arranges for its shipment and if requested provides the European purchasers with certain services connected with the use of the chemical. The legislative history of H.R. 13103 suggests that if an office outside the United States performs "significant services incident to such sale which were necessary to its consummation and were not subject to a separate agreement between the seller and the buyer," such office will be considered "to have participated materially" in the sale so as to exclude the income from capture under Category (iii). The only activities specifically referred to in the legislative history as constituting "material" participation in the sale are solicitation and negotiation of sales which, in the present example, would be taking place through the United States sales office. Certainly the risk of tax in the foregoing example would discourage establishment of a sales office in the United States.

It should be noted that under the Bill the general effect of a finding that income from without the United States falling in one of these specified classes is "effectively connected" with a United States trade or business, will be to impose United States tax upon all of such income. This would seem a completely untoward result since not infrequently the activities carried on by the United States place of business will, in an economic sense, have generated only a fraction of the income in question. For instance, in example (i), above, the ownership of the patent rights in the particular country will have been the principal source of such income viewed in an economic sense. Therefore, if Section 864(c)(4)(B) is to be retained in something resembling its present form, provision should be made for allocating to the United States place of business only that portion of the income in question which is economically attributable to the United States place of business. This might be done by adopting principles of allocation under section 482 of the Code such that the U.S. office would be taxed upon the portion of the income in question attributable to its selling or negotiating function.

Effective Date. Excluded from consideration in determining whether income from non-United States sources is to be treated as effectively connected income are activities attributable to a binding contract entered into on or before February 24, 1966, carried out "in the United States on or before such date in negotiating or carrying out such contract." It is suggested that the description of excluded activities parallel the statutory language contained in proposed Section 864(c)(4)(iii), just discussed, as follows: "activities conducted through an office or other fixed place of business within the United States."

B. Income from Sources within the United States

As noted above, we agree in principle with the use of the "effectively connected" concept to free from regular rate taxation investment income of foreign taxpayers notwithstanding their being engaged in trade or business in the United States. The statutory "effectively connected" test is necessarily vague, and, as a result, it will be difficult in many instances to advise nonresident aliens with any degree of specificity whether or not passive income will be considered "effectively connected."

One of the difficulties arises from the use of an accounting factor in determining whether income is "effectively connected." This is a carryover, somewhat modified, from the definition of "effectively connected" in H.R. 11297. Under the proposed statute, the determination of whether investment and other fixed or determinable income and capital gains from United States sources is "effectively connected" with a United States business is made on the basis of whether

(a) the income is derived from assets used, or held for use in the conduct of a United States business, or

(b) the activities of the United States business were a material factor in the realization of the income.

In determining whether factor (a) or factor (b) is present in a particular case, the statute provides that "due regard shall be given to whether or not such asset or such income, gain or loss was accounted for through such trade or business." In H.R. 11297, this "accounting" factor was on a par with the other two factors, (a) and (b), in determining whether income was effectively connected with a trade or business. The use of an accounting factor in the statutory definition does not in the first instance seem desirable, although it is certainly better to reduce it from its status under H.R. 11297 where the presence of such factor alone might have resulted in treatment of income as effectively connected income.

The basic definition in the statute of what constitutes "effectively connected" income is followed by a catchall definition of other types of income to be treated as effectively connected income, irrespective of whether so connected in fact (proposed Section 864(c)(3)):

"(3) OTHER INCOME FROM SOURCES WITHIN UNITED STATES.—All income, gain, or loss from sources within the United States (other than income, gain, or loss to which paragraph (2) applies) shall be treated as effectively connected with the conduct of a trade or business within the United States."

The income, gain, or loss "to which paragraph (2) applies" (that is, Section 864(c)(2)) is, in turn, described by cross-reference to other sections of the Code. It is suggested that the same cross-references be made in Section 864(c)(3) so that the parenthetical portion of Paragraph (3) would read as follows:

"* * * (other than income from sources within the United States of the types described in section 871(a)(1) or section 881(a) or gain or loss from sources within the United States from the sale or exchange of capital assets)"

THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

COMMITTEE ON TAXATION

Comments on H.R. 11297: "*Foreign Investors' Tax Act of 1965*"

Members of the Committee

Laurence F. Casey, *Chairman*	James A. Glascock, Jr.
Robert Arum	Donald H. Kallman
Joseph E. Bachelder, III	Saul Duff Kronovet
John C. Baity	James A. Levitan
John L. Cady	Donald R. Osborn
Wallace J. Clarfield	James R. Rowen
John A. Corry	David G. Sacks
Willis L. Ensign	David Simon
John W. Fager	Orrie P. Stevens, *Secretary*
Arthur A. Feder	Robert W. Wales
Wilbur H. Friedman	David E. Watts

Set forth below are the comments of the Committee on Taxation of the Association of the Bar of the City of New York on H.R. 11297.

According to the Ways and Means Committee's Summary, a principal purpose of the bill is to encourage foreign investment in the United States—thereby beneficially affecting the United States balance of payments—by removing tax barriers to such investment. The Committee believes that certain changes made under the bill will have precisely the contrary effect. For instance, the elimination of the income and estate tax exemptions relating to United States bank deposits must lead to withdrawals of substantial existing deposits from, and discourage potential deposits in, this country.

One further aspect of the bill may well serve to discourage investment in the United States. Under present law, it is possible to give fairly definite advice to a foreign corporation or partnership wishing to establish a branch in this country as to what part of its income will be treated as income from sources within the United States and subject to tax here. H.R. 11297 would abandon the use of these clearly defined "source" rules and instead subject to United States tax all income that is "effectively connected" with a United States branch operation. The "effectively connected" concept is vague and ill-defined. To the extent that the bill substitutes an unclear standard of taxability for a clear one, making it more difficult for a foreign investor to determine what United States tax he will pay, it will, in the Committee's opinion, serve to discourage investment in the United States.

Our detailed comments are submitted under six principal headings, as follows:

Source of Income

Section 2(a). Interest

The general effect of this provision is to extend the present exclusion of interest on bank deposits from U.S. source income to interest paid by savings and loan associations and to interest paid on amounts held by an insurance company under an agreement to pay interest thereon. However, with one minor exception described below, the present exclusion of bank deposit interest from U.S. source income as well as the proposed extension will terminate on December 31, 1970. Thus, all such interest paid or credited after December 31, 1970 will be subjected to a 30 percent withholding rate (or to any lower treaty withholding rate). It it believed that such change, even though deferred to 1970, will tend to discourage new deposits of substantial sums with U.S. banks, as well as encouraging the withdrawal of substantial deposits presently held by foreigners.

Section 2(a) of the bill adds a new subparagraph to the Code excluding from "U.S. source income" interest paid on foreign currency deposits in foreign branches of U.S. banks, a change which is necessary because of the proposed termination of the present exclusion of bank interest from U.S. source income. This provision is desirable but should be extended to cover all interest paid by foreign branches of U.S. banks. If interest on dollar deposits in foreign branches of U.S. banks is subject to U.S. withholding taxes, such branches will be noncompetitive with local foreign banks. The resulting reduction in their earnings may tend to worsen the U.S. balance of payments. Should the above restriction induce the incorporation of their foreign branches by U.S. banks, the balance of payments may be further worsened by the accumulation of their earnings free of U.S. tax in such incorporated branches.

Section 2(b). Dividends from foreign corporations

This section modifies present Code section 861(a)(2)(B) to provide that dividends from a foreign corporation are to be considered income from U.S. sources only if 80 percent of the corporation's gross income for the preceding 3-year period consisted of income effectively connected with the conduct of a trade or business within the United States. This change represents a marked liberalization of the present requirements for exclusion of dividends of foreign corporations from U.S. source income and the Committee questions the necessity therefor. Presumably the change is designed to eliminate the so-called "second dividend tax", particularly with respect to investment income. However, where a foreign corporation is carrying on activities here which are effectively connected with a U.S. trade or business, there would seem to be no reason why the withholding tax should not apply. Accordingly, it is suggested that the present requirement be retained, or more appropriately, reduced below 50 percent.

In any event, in the interest of clarity, the word "total" should be added before the words "gross income" where they first appear in the subparagraph and the words "from all sources" should be added after the words "gross income". Since under the bill provisions (Sec. 4(b)) amending section 882(b), the "gross income' of a foreign corporation would be limited to income from sources within the United States plus "effectively connected" income, Section 861(a)(2)(B), as proposed, would produce an unintended result.

Section 2(c). Personal services

This provision desirably broadens the present exclusion from U.S. source income of the earnings of employees of (i) foreign corporations or (ii) foreign branches of U.S. corporations who earn less than 3 thousand dollars and are present here for less than 90 days, the exclusion being extended to employees of foreign offices of U.S. partnerships or individuals. No change has been made in the basic 3 thousand dollar exclusionary test. Since this figure has been part of the Code at least since 1939 (and apparently has its genesis in § 201(c) of the Revenue Act of 1917), and since wage levels have increased materially in that period, consideration might be given to increasing this amount.

The exclusion presently applies to employees of foreign corporations, etc. where the employer is not engaged in trade or business in the United States if the employee is employed by a foreign office of the foreign employer. There would seem to be no basis for putting employees of a foreign branch of a foreign employer engaged in trade or business here in a worse position than that of employees of a foreign branch of a U.S. corporation. Section 861(a)(3)(C)(i) of the Code and proposed section 864(b)(1)(A) should be amended to extend this exclusion to employees of a foreign branch of a foreign employer engaged in business in the United States.

Section 2(d). Definition of "trade or business within the United States"

Proposed Code section 864(b)(2)(A) would provide that trading in stocks or securities through a resident broker custodian or other agent having discretionary authority would not constitute the carrying on of a trade or business within the United States. This is a desirable amendment which should aid in effectuating the purposes of the bill. The Treasury Department release of March 8, 1965, accompanying H.R. 5916, stated that no legislative change is necessary to provide that the volume of transactions is not material in determining whether an investor is engaged in trade or business in the United States since this is the rule under existing law. It is not believed that existing law in this regard is as clear as the Treasury release would indicate and it is therefore suggested that a specific clause be inserted in the proposed section 864(b)(2) affirmatively stating that the volume of securities or commodities transactions is not material in the determination of whether an investor is engaged in trade or business within the United States.

Income "effectively connected" with a U.S. trade or business

The bill actually utilizes the "effectively connected" concept for two purposes. First, the concept is used to determine whether dividends, interest, royalties and other ordinarily "passive" types of income which are admittedly subject to United States tax are part of the income of a U.S. trade or business and properly subject to full rates of U.S. income tax or subject only to normally lower withholding tax rates. This use of the "effectively connected" concept parallels its use in the recent protocol to the U.S.-German Income Tax Convention and in the O.E.C.D. Draft Double Taxation Convention. To this extent the use of the concept is proper and desirable, even recognizing the areas of question which underlie its interpretation. However, the bill then uses the "effectively connected" concept in a way in which it is not used in U.S. tax conventions or in the O.E.C.D. Draft. It is this second use of the concept which the Committee believes represents a serious and undesirable departure from present law.

Under present law if a foreign corporation or nonresident alien is engaged in trade or business in the United States, then United States tax is imposed on the industrial and commercial income[1] of that trade or business to the extent that it is "from sources within the United States." I.R.C. §§ 872(a), 882(b). The Code and Regulations contain fairly precise definitions of what is and is not income from sources within the United States and the case and other authority is now sufficiently clear so that definite answers can be given to the bulk of source of income questions arising in connection with industrial and commercial income. However, the bill would discard all of these established and well-understood rules and would treat as income of the foreign person's U.S. trade or business *all income* "effectively connected" with that trade or business without reference to its "source".

Proposed section 864(c) would provide a series of fairly amorphous "factors" which are to be "taken into account" in determining whether income is "effectively connected" with a United States trade or business. These "factors" provide no answers to the following everyday questions that will necessarily arise in applying the "effectively connected" concept. If goods are processed here and then shipped to a foreign country where they are sold through stores, with the benefit of extensive advertising, what part of the profit on sale is "effectively connected" with the trade or business carried on in the United States? What portion of the income from a sale of goods is effectively connected with the U.S. trade or business if goods are processed both here and abroad and then sold abroad? Suppose that the foreign corporation holds foreign patents, without which goods manufactured here could not be sold abroad. Does this affect the amount of income "effectively connected" with the U.S. trade or business? Suppose that a foreign corporation managed in this country operates oil fields throughout the world. What portion of its income is "effectively connected" with its U.S. trade or business?

There would seem to be only two alternative solutions in each of the foregoing cases. Either the entire income from the entire industrial and commercial income producing activity here and abroad is subject to U.S. tax or only part is so subject. If it is intended to subject all of such income to tax, this certainly represents a drastic and questionable change in our tax system. If only part of the income from the entire profit-making activity is subject to U.S. tax then "source" rules will have to be provided and the bill simply becomes a vehicle for the rewriting of the source of income rules; and if this is what is intended, the rules should be set forth specifically in the bill and should not be left to Committee Reports or "guidelines."

The Committee believes that this second and novel use of the "effectively connected" concept should not be adopted. Well-defined principles provided by the present source rules should be retained for purposes of determining what part of the industrial or commercial profits of a foreign person engaged in trade or business in the United States are to be taxed by the United States. This can be done by adding the words "from sources within the United States" after the words "gross income" in proposed section 882(b)(2) and after the words "gross income" the second time that they appear in proposed section 872(a)(2). Similar changes would be required in other provisions of the bill where the "effectively connected" phrasing appears.

Adoption of the "effectively connected" concept will mean the imposition of United States taxes on income of foreign corporations not presently subject thereto; and as this occurs, the risk of double taxation of the same include will increase notwithstanding the foreign tax credit and extension thereof proposed in section 6 of the bill. This provision would allow to foreign taxpayers engaged in trade or business in the United States a credit not presently allowed for foreign taxes imposed upon income "effectively connected" with the U.S. trade or business. The credit would not be allowed with respect to taxes which would not be imposed by the foreign jurisdiction but for the fact that the taxpayer was a citizen or resident of such country or was incorporated in that country. The Committee believes that it will be extremely difficult in many cases for taxpayers

[1] The Code does not use the term industrial or commercial income. The term as used here provides a convenient description of the types of income which will be affected by this change in present law.

to demonstrate that a particular tax would not have been assessed but for the fact of the taxpayer's citizenship, residence or incorporation in the foreign jurisdiction.

Non-resident aliens

Section 3 would establish new rules for the application of the income tax to non-resident aliens.

1. The Committee believes that the following substantive changes are sound and are appropriately carried out by the proposed bill.

(a) Non-resident aliens would be taxed separately on income effectively connected with a United States trade or business and income not so connected. Under the proposed bill, income not effectively connected with United States trade or business will be taxed at a 30 percent rate (or at a lower treaty rate, if applicable), and income which is effectively connected with a United States trade or business will be taxed at the regular graduated rate applicable to individuals. Under present law, the graduated rates apply only if non-resident aliens are engaged in trade or business in the United States or if their income exceeds $21,200.

(b) A non-resident alien is not to be subject to United States tax on capital gains unless he is here for more than 183 days during the year or unless such gains are effectively connected with a United States business.

(c) Every non-resident alien, irrespective of whether he is engaged in business here, may elect to treat certain real property and mineral income as connected with a business in order to obtain deductions (such as depreciation and depletion) attributable to such income.

2. A major change proposed by the bill is that, in determining the taxation of a non-resident alien engaged in business here, an alien is to be taxed on his taxable income which is effectively connected with the trade or business conducted in the United States. While precise rules are not spelled out, it appears that the concept is intended to be broader than the present concept of gross income from United States sources. For the reasons stated in the discussion of Section 2 of the bill, it is believed that this change is inadvisable.

3. The withholding rules are amended to eliminate withholding on any item of income (other than compensation for personal services) which is effectively connected with conduct of a trade or business in the United States. It is believed that withholding should continue to be governed by the source of income rules, as these provide a much more objective and practicable standard for a withholding agent. At least, withholding should continue to be required with respect to dividends and interest. Under the proposed changes, there would be too great an incentive for persons to file false information with the withholding agent.

4. The definition of periodic income from United States sources (income subject to 30% tax) would be expanded to include income from the sale or liquidation of a collapsible corporation (Section 341) and from original issue discount (Section 1232). The Committee believes that this extension of the definition of "periodic income" is inadvisable. The change would not result in any appreciable increase in tax collections, since the tax could easily be avoided by selling outside of the United States. Since it is sometimes difficult to know whether or not Section 341 or Section 1232 is applicable in the first instance, this expansion would tend to increase the uncertainty of taxation of non-resident aliens, which the proposed bill is supposedly designed to reduce.

5. As noted above, a non-resident alien may elect to treat income from certain real property as connected with a business in order to obtain the benefit of deductions attributable to such income. This election is equally applicable to a foreign corporation and the following comments are pertinent both to the election available to a non-resident alien individual and the election available to a foreign corporation.

The Committee recommends that the election be extended to include personal property "associated" with the real property involved. For example, if a non-resident makes the election with regard to a hotel subject to a net lease, such election would also relate to all personal property in the hotel subject to the lease, so that the non-resident woud not have one rule applying to the hotel lease and another rule applying to the lease of the personality associated with the hotel. Also, it is not clear whether the election would extend to interest from mortgages on real property. Under the various tax conventions mortgage interest, more often than not, is specifically excluded from the concept of "income from real property." It is therefore recommended that proposed Section 871 (d)(A) be amended to make it clear that interest from mortgages on real property is not "income from real property". A similar change should be made in proposed Section 882(d).

Proposed Sections 873(a) and 882(c)(1)(A), in providing for the allowance of deductions and credits in respect of United States income, limit the deductions to circumstances in which they are "effectively connected with the conduct of a trade or business within the United States." It is recommended that these proposed sections be changed by inserting "attributable to income" which is immediately preceding the phrase quoted in the preceding sentence, so that it is clear when an election is made to treat real property income as income connected with a United States business that such election effectively permits the nonresident to obtain the offsetting deductions, the purpose of the election in the first instance.

Finally, the Committee questions whether the election under Sections 871(d) and 882(d) should extend to gains described in present Code Section 631 (b) or (c). Since such gains are also defined as periodic income, it would appear that a nonresident individual or corporation would always make the election in order to obtain a lower effective tax rate and possible use of such deductions against other business income.

Foreign corporations

Under Section 4, a foregoing corporation engaged in trade or business in the United States, like a non-resident alien similarly so engaged, would be taxed as if it were a resident on its taxable income which is effectively connected with the trade or business conducted here. Again, it appears that the concept of "effectively connected with the trade or business" is intended to be broader than the present concept of gross income from United States sources. For the reasons stated in the discussion of section 2 of the bill it is believed that this change is inadvisable.

Section 4(a). Tax on income not connected with United States business

The title suggested for proposed Code section 881, "Income of Foreign Corporations not Connected with United States Business," fails to indicate, as it should, that a tax is imposed by that section. Accordingly, it is recommended that the section's title be amended by the addition of "Tax on" at the beginning thereof.

Proposed section 881(a)(1), reflecting changes made in proposed section 861(a)(1)(A), would eliminate from the category of nontaxable interest, interest on deposits with persons carrying on the banking business. For the reasons stated in the discussion of section 2(a) of the bill, it is believed that this change is inconsistent with the purpose of the bill to encourage foreigners to invest in the United States.

Proposed section 881(a) also would expand the definition of periodic income from United States sources (income subject to 30% tax) to include income from the sale or liquidation of a collapsible corporation (section 341) and from original issue discount (section 1232). For reasons stated in the discussion of section 3 of the bill it is believed that this extension of the definition of "periodic income" is inadvisable.

Section 4(b). Tax on income not connected with United States business

It is recommended that the title to proposed section 882 be changed by adding at the beginning thereof the words "Tax on." It is recommended that subsection (a) of proposed section 882 be changed to read as follows:

"(a) Imposition of tax—A foreign corporation engaged in trade or business within the United States during the taxable year (or during any preceding taxable year beginning after December 31, 1965) shall be taxable as provided in section 11 or 1201 (a) on its taxable income determined on the basis of its gross income as described in subsection (b)(2)."

The caption, "Imposition of Taxes," would be consistent with the caption to proposed section 881(a) and the intended limitation of taxable income can be accomplished without a separate paragraph.

Proposed section 882(c)(1)(A), in providing for allowance of deductions and credits in respect of United States business income, limits the deductions to circumstances in which they are "effectively connected with the conduct of a trade or business within the United States." For reasons already given in respect of the similar provision affecting non-resident alien individuals in section 3 of the bill, it is recommended that the proposed section 882(c)(1)(A) be changed by inserting "attributable to income" immediately preceding the phrase quoted in the preceding sentence.

Proposed section 882(d)(1)(A) permits a foreign corporation to treat gains described in present Code section 631 (b) or (c) as income connected with a United States business. For reasons stated in the discussion of section 3, in respect of the similar election granted to non-resident aliens, it is believed that this election in respect of section 631 (b) or (c) income is not desirable.

Proposed section 882(e) would seem to prohibit a direct filing of a return by a foreign corporation in the circumstances there described. It is recommended that, in order to assure that the foreign corporation may itself file the return, the words "unless such return is made by such foreign corporation" be added at the end of the sentence.

The withholding rules are amended to eliminate withholding on any item of income (other than compensation for personal services) which is effectively connected with the conduct of a trade or business in the United States. As stated in respect of section 3 of the bill it is believed that withholding should continue to be governed by the source of income rules.

Section 4(b)(3) of the bill, containing proposed changes in the table of sections for subpart B of part II of subchapter N of chapter 1, should be changed to reflect the above-recommended changes in the titles to sections 881 and 882. Thus, the words "Tax on" should be inserted at the beginning of the titles given for sections 881 and 882.

Section 4(d). Dividends received from certain foreign corporations

It is recommended that the amendment of section 245(a) of the Code, as proposed in section 4(d)(1) of the bill, be changed by adding "total" before "gross income." Compare present Code section 542(c)(7)(A). The addition of "total" would seem to negate any argument that the various statutory exclusions applicable to gross income of foreign corporations, see, for example, present Code section 883, should be taken into account in determining gross income for this purpose.

Section 4(f). Corporations subject to personal holding company tax

The proposed section 542(c) would change the present rule for excluding certain foreign corporations from classification as a personal holding company. Under the proposed rule indirect ownership by non-resident alien individuals through foreign estates, foreign trusts, foreign partnerships as well as through other foreign corporations would be taken into account. It is unclear why attribution through partnerships is limited to foreign partnerships. It is recommended that the word "foreign" immediately preceding "partnerships" be deleted.

Section 4(g). Foreign corporations carrying on insurance business in the United States

It is recommended that the title to proposed section 842 be changed by adding at the beginning thereof the words "Tax on". A corresponding change would be required in paragraph (2) of section 4(g) of the bill, which would amend the table of sections for Part IV of subchapter L of chapter 1 of the Code.

Estate and gift taxes

The Task Force recommended the elimination of the federal estate tax on intangible property of nonresident alien decedents. It is widely believed that the estate tax is a significant deterrent to foreign investment in United States securities. Nonetheless, the Treasury decision in presenting H.R. 5916 to retain an estate tax with relatively large exemption ($30,000) and with relatively low rates (a maximum of 15% and only 5% on the first taxable $100,000) was probably warranted. The Committee takes no position regarding the desirability, from the standpoint of encouraging United States investments, of the proposed maximum 25% rate instead of the 15% maximum rate proposed in H.R. 5916.

Section 8(b) would provide a new technical limitation on the credit for state death taxes. Though arguments can be made as to a limitation keyed to the kind of limitation that a domiciliary of the United States might have, in the context of a bill designed to reassure foreigners with respect to the low impact of death duties in this country, the introduction of any such limitation seems undesirable. In addition, the limitation may operate somewhat unevenly depending upon how many intangible assets the decendent had which were not assignable to any state of the United States.

Section 8(c) would amend Section 2104 to make it clear that where a debt obligation of a United States obligor is owned by a non-resident alien, the obligation shall be treated as property within the United States no matter where it is located. However, it should also be made clear that a foreign obligation physically located in the United States will not be treated as property within the United States, a result which would be only a logical extension of the proposal with respect to United States obligations. The same comment can be made respecting section 9(b) which would amend section 2511(b) to set forth similar situs rules in the gift tax area.

Expatriation

Sections 3(e), 8(f) and 9(a) contain alternative provisions designed to penalize for income, estate and gift tax purposes, certain persons who surrender their United States citizenship for the purpose of reducing their U.S. taxes. The Task Force on Promoting Increased Foreign Investments did not recommend such penalties and it may be questioned whether, on the one hand, the position of nonresident aliens is so greatly improved by the bill that U.S. citizens not otherwise prompted to expatriate themselves for tax reasons will now be induced to do so or, on the other hand, whether the penalties themselves are severe enough to prevent significant tax advantage from being gained for such surrender—as to justify adding these complexities and uncertainties to an already overburdened Code. How, for example, can the Commissioner, with any semblance of uniformity of treatment, proceed to establish that "it is reasonable to believe" that an expatriate would have gained, but for proposed section 877, a "substantial" reduction of taxes on "probable income" for the year? In the case of estate tax on expatriates, would the "substantial" reduction in taxes be computed by reference to assets owned at expatriation or those owned at death, possible ten years later? Enforcement of such a provision can hardly be uniform; and lack of uniformity is further suggested in the exception provided for cases of dual citizenship. Moreover, it seems questionable whether, from a national policy standpoint, the United States should undertake such measures against persons willing to surrender their citizenship.

Section 3(e). Expatriation to avoid tax

It is recommended that the title of proposed section 877 be changed to "Tax on Certain Expatriates". Compare titles of other sections in part II of subchapter N of chapter 1, particularly sections 871, 881 and 882.

The clause starting with "if the tax" in the last two lines of subsection (a) of section 877 should be changed to read as follows: "if the tax for the taxable year computed pursuant ot such subsection exceeds the tax for the taxable year computed without regard to this section."

In making computations to determine the applicability of an alternative tax it would not seem appropriate to speak of a "tax imposed". See, e.g., section 1341(a) of the Code.

In the second line of subsection (c)(1) of proposed section 877, "debt obligations" (in the title and text) should be changed to "evidences of indebtedness", in order to conform to the terminology used in other areas of the Code, e.g., sections 164 and 1232.

Section 8(f). Special methods of computing estate tax

It is recommended that the title of section 2107 be changed to "Tax on Estates of Certain Expatriates".

Section 9(b). Gift tax transfers

In subsection (b)(2) of section 2511 "debt obligations" should be changed to read "evidences of indebtedness".

STATEMENT OF THE COMMITTEE ON FEDERAL TAXATION OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, SUBMITTED BY DONALD T. BURNS, GENERAL CHAIRMAN OF THE COMMITTEE

COMMENTS AND RECOMMENDATIONS REGARDING H.R. 13103, FOREIGN INVESTORS TAX ACT OF 1966

General Comments

H.R. 13103 is a modified version of H.R. 11297 which, in turn, was a modified version of H.R. 5916. Frankly, we believe that the previous successive modifications have overly diluted the original intent of the legislation, which was to encourage foreign investment in the United States, and thereby improve the U.S. balance of payments.

H.R. 5916 was designed to stimulate foreign investment in the United States by removing existing tax barriers to such investment. It would have revised or eliminated many of the provisions in the present law which tended to complicate or inhibit investment in U.S. securities. For this reason, the Institute's committee on federal taxation favored the proposed legislation, although in its comments submitted to the Committee on Ways and Means of the House of Representatives on June 25, 1965 it recommended certain changes and clarifications.

The new version of the bill, H.R. 11297, differed dramatically from its predecessor. It introduced an entirely new idea of taxing foreign source income under an elusive "effectively connected" concept, provided for the income and estate taxation of deposits in U.S. banks, and provided for higher estate tax rates on nonresident alien decedents. The specific factors which led to the adoption of such changes were not made clear. The Institute's committee on federal taxation opposed such changes in comments submitted to the House Ways and Means Committee on January 12, 1966.

H.R. 13103 modified considerably the objectives of the initial bill. On page 6 of the report of the House Ways and Means Committee it is stated, "While the initial bill proposed by the Treasury Department was designed primarily to stimulate investments by foreigners in the United States, your Committee considered more generally the tax provisions of present law affecting nonresident aliens and foreign corporations."

H.R. 13103 as presently constituted does eliminate some of the objectionable provisions of H.R. 11297; however, H.R. 13103 still contains proposed amendments to the current law that we feel are highly questionable:

1. The introduction of an entirely new concept, that non-resident aliens and foreign corporations engaged in trade or business in the United States would be taxed on certain *foreign source* income as well as U.S. source income "effectively connected" therewith. Current law taxes such persons on their *United States source* income only.

2. After 1971, interest on United States bank deposits would be subject to United States tax although paid to persons not engaged in business here.

3. United States bank deposits would be included in the gross estate of nonresident alien decedents even though not engaged in business in the United States.

Introduction of these new concepts and other changes and the uncertainties created thereby will have the effect of:

a. Forcing foreign controlled businesses with operations in the U.S. to relocate those operations outside the Uinted States, thus resulting in the loss of commercial contacts in the U.S., possible loss of exports, jobs, etc.

b. Causing foreign businesses to change plans for opening operations in the U.S. due to the complexity of U.S. tax laws.

c. Forcing the withdrawal of foreign deposits in U. S. banks, and stopping the further flow of funds to the U.S., thus aggravating our current serious balance of payments problem.

We are aware of the many complex problems inherent in the preparation of this legislation, but we strongly feel that many of the proposed changes in existing law will adversely affect the U.S. economy.

Specific Comments and Recommendations

Bill section 2

1. Proposed code section 861(a)(1)(A) and 861(c)

Interest on U. S. bank deposits (page 4, lines 9–14; page 5, lines 1–21): The effect of the proposed amendments would be to broaden the exemption from U.S. tax for certain interest income for a five year period, but would subject interest on U.S. bank deposits and similar amounts to withholding of tax at source with respect to payments after December 31, 1971. There are two obvious reasons for questioning the proposed withdrawal of the exemptions:

1. The basic exemption which has been in force since 1921, has been considered desirable to encourage the use of U.S. banks by foreign persons for deposits and financial transactions.

2. The nexus of such taxation of income from U.S. bank deposits is so slender as to raise doubts as to the rationale for the change.

While the imposition of tax would be delayed for several years, it is not considered desirable because it creates another complication regarding investment in the United States. Such complications certainly act as a *current* psychological deterrent to U.S. investment by nonresident aliens, even though the actual impact of U.S. withholding tax will not occur until 1971.

Bill section 3

2. Proposed code section 871(a)

Subject of the tax on non-resident alien individuals (page 18, lines 3 and 17): In proposed Section 871(a)(1), the words "gross" income should replace the words "amount received." In Regulations Section 1.871-7(b)(1) there is the following clarification: "For the purpose of Section 871(a)(1) 'amount received' means 'gross income'."

3. Proposed code section 871(a)

(Page 18, lines 5-7): This proposed subsection describes the kinds of income *not* connected with a United States business which shall be subject to tax at the rate of 30 per cent. It repeats the enumeration of the types of income presently described in Section 871(a)(1), including the words "salaries," "wages," "compensations," "remunerations," and "emoluments." Under proposed Section 864(b) the performance of personal services within the United States will constitute engaging in a trade or business within the United States except under certain limited circumstances. Remunerations for such personal services, therefore, would be taxed at graduated rates under proposed Section 871(b) as income effectively connected with the conduct of a trade or business within the United States. Accordingly, proposed Section 871(a) should be revised to exclude the terms cited above which are descriptive of payments for personal services.

4. Proposed code section 871(a)(2)

Determination of capital gains of aliens present in the United States 183 days or more (page 18, lines 20-24; page 19, lines 1-24): It is assumed that the intent of the Bill is to subject nonresident aliens who are present in the U.S. for 183 days or more during a year to a 30% rate of tax. This provision places such an alien in a disadvantageous position in comparison with a domestic investor, because under the provisions of lines 11-15, page 19 the capital gain deduction and capital loss carryover provisions are not to be allowed. While the 183 days is a liberalization of current law, there should be further relief. We recommend that the rate of tax be 25 per cent and that consideration be given to allowing the deduction of capital loss carryovers.

5. Proposed bill section 871(b) and 882

Income "effectively connected" with a U.S. trade or business (page 20, lines 3-8, and page 37, lines 8-13): It is proposed that nonresident aliens and foreign corporations engaged in trade or business within the United States would be subject to regular rates of tax on certain foreign source as well as U.S. source income "effectively connected" with such trade or business. This is the most questionable provision in the bill because it represents a drastic extension of U.S. taxing jurisdiction and unduly complicates U.S. taxation of foreign persons. Heretofore foreign corporations and nonresident alien individuals engaged in trade or business here have been subject to U.S. income tax only on U.S. source income.

It has been said that the adoption of the "effectively connected" concept is in accord with the OECD Model Income Tax Convention and with our new treaty approach as evidenced by the recent protocol with Germany. Our study of these documents and of the reports of the Department of State and of the staff of the Joint Committee on Internal Revenue Taxation on the German protocol has disclosed no indication that foreign source income would be taxed.

Article III of the Convention with Germany as amended, dealing with the taxation of the industrial or commercial profits of an enterprise, does not even use the term "effectively connected" and Article XV, dealing with the avoidance of double taxation, limits the allowable tax credits and/or exclusions from taxable income to income having its *source* in the other country.

We believe that enactment of H.R. 13103 could lead to serious problems of double taxation, particularly with regard to foreign subsidiaries of U.S. corporations. If such foreign subsidiary were subjected to U.S. taxes under this principle, double taxation would result when the U.S. parent corporation receives dividends from the subsidiary since no credit is permitted for U.S. income taxes paid by a foreign corporation. (Relief under the proposed Section 245 would in most cases be wholly inadequate.) It is recognized that a motivating factor in this proposal to tax foreign persons engaged in trade or business in the United States on certain of their foreign source income is concern that otherwise tax avoidance may be permitted. We do not believe that major U.S. tax avoidance does result under the existing provisions for taxation of such foreign persons. The Treasury has various ways of dealing with efforts to avoid U.S. income taxes, such as Section 482, arrangements under various income tax treaties, and its ability to challenge such devices as the mere arrangement of title passage outside the United States for tax avoidance purposes.

The majority of our existing tax treaties contain provisions which limit the imposition of tax to income from sources within the taxing country. These include Australia, Austria, Denmark, Finland, Greece, Honduras, Ireland, Italy, Japan, Luxembourg, New Zealand, Norway and Switzerland. Since H.R. 13103 provides that the changes which it would make in U.S. tax law would not contravene any existing treaties, the treaties with the above-named countries would require amendment before the foreign source income of their corporations could be taxed by the United States.

The foreign tax credit proposed under new Section 906 would not be allowed for taxes paid to a country solely by reason of the foreign person being domiciled there for tax purposes. This can obviously result in double taxation where the country of domicile imposes limitations on allowable credits for foreign taxes which are similar to the United States rules. In such a case, where the United States taxes income which is derived from a third country, the country of domicile would not permit a foreign tax credit for the U.S. taxes paid on income derived from the third country.

It should be noted that the foreign source income which may be taxed under the "effectively connected" provisions may be greater than that actually commensurate with the functions performed by the office in the United States.

The uncertainties and possible tax inequities resulting from the "effectively connected" concept will most likely discourage U.S. portfolio investment by foreign persons engaged in trade or business here, because in many cases they could not be sure of obtaining the generally lower rates of tax on investment income.

For the foregoing reasons we believe that it would be preferable to provide that a foreign corporation or a nonresident alien individual engaged in trade or business in the United States be taxed at regular rates only on its *U.S.-source* income "effectively connected" with the U.S. trade or business.

Bill section 4

6. Proposed code section 882(c) (2)

Softening of provision disallowing all deductions for failure to file a return (page 39, lines 1-12): The disallowance of all deductions and most credits for failure to file a return under proposed Section 882(c) (2), is an unusually harsh provision. Even though this provision is a part of the present law, the purposes of the Bill would seem to indicate that the provision should be softened.

7. Proposed code section 245(a)

Dividend received deduction (page 43, lines 5–24; page 44, lines 1–9): Consideration should be given to permitting a 100 per cent dividends received deduction to U.S. corporations with respect to an 80% or more owned foreign subsidiary to the extent that the distribution is entitled to a dividend received deduction, otherwise an up-stream dividend tax will be unjustly imposed. It should also be observed that the qualifying period under proposed Section 861(a) and amended Section 245 continue to be different.

We also urge that Code section 245 be amended to substitute the term "10 per cent" wherever the term "50 per cent" presently is used. This would permit a fractionalized dividends received credit in the majority of cases and would ameliorate, although not eliminate, the double taxation problems which we have described above.

Bill section 6

8. Proposed code section 901(c) and 2014(h)

Consistency in provisions requiring thirty-day notice prior to Presidential proclamation (page 66, line 15, and page 67, line 19; cf. page 55, lines 8–12 and page 79, lines 8–12: To be consistent with proposed Section 896 and 2108, proposed Sections 901(c) and 2014(h) should require a thirty-day notice to Congress before a proclamation is made by the President.

9. Proposed code section 904(f) (2)

Foreign tax credit in case of certain overseas operations funding subsidiaries (page 68, line 9 through page 70, line 2): The amendment would make the present "per country" limitation with respect to interest income inapplicable to interest received by an "overseas operations funding subsidiary" on obligations of a "related foreign corporation." The provisions of this section are too restrictive. It is recommended instead that the provisions of Section 904(f)(2)(c) be amended to provide an exception for interest received from a corporation in which the taxpayer or an affiliated corporation owns directly or indirectly at least 10% of the voting stock.

Bill section 8

10. Proposed code section 2101(a)

Rate of estate tax on nonresident alien decedents (page 71, lines 19–21 and page 72, lines 1–2): The Fowler Task Force Report contained a recommendation to "eliminate U.S. estate taxes on all intangible personal property of nonresident alien decedents." We believe this recommendation should be followed. As pointed out in the report:

"Under existing U.S. tax law, a foreigner willing to go therough the expense and trouble of establishing a personal holding company, incorporated abroad, and assuring himself that this personal holding company does not run afoul of the U.S. penalty taxes or undistributed personal holding company income, can already legally avoid estate taxes."

The possibility of using such a holding company would be made even easier due to a provision in the bill which would exempt from the personal holding company tax a foreign corporation if all of its stock is owned by foreigners.

Sophisticated investors may take advantage of this means of escaping estate tax; others will reject the complications and additional costs. It would seem preferable to enable both types of investors to acquire U.S. securities without concern for a substantial U.S. estate tax.

11. Proposed code section 2105(b)

Inclusion of bank deposits in the gross estate (page 74, lines 3–7): The bill would remove the existing exemption from the gross estate for U.S. bank deposits owned by a nonresident alien decedent who was not engaged in business in the United States at the time of his death. This provision should be eliminated from the bill since, if enacted, it is likely to have an immediately adverse effect on the U.S. balance payments.

The exclusion of bank deposits from the gross estate would also result from the adoption of the recommendation in item 9 above. In any event, as far as bank deposits are concerned, the proposed inclusion in the gross estate is clearly in the wrong direction."

COMMENTS OF THE WORLD TRADE CENTER IN NEW ENGLAND, INC. ON H.R. 13103 SUBMITTED BY PATRICK FITZPATRICK, PRESIDENT

I. SUGGESTIONS FOR TECHNICAL CHANGES IN H.R. 13103

1. H.R. 13101 proposed to substitute for the term "resident foreign corporation" in section 882 of the Internal Revenue Code the new concept "effectively connected with the conduct of a trade or business within the U.S." Consequently, sections 861(a)(1) and 861(a)(1)(B) which still refer to "resident foreign corporations" require conforming amendments.

2. H.R. 13103 provides for the addition of section 896 to the Internal Revenue Code which, under appropriate circumstances, makes the existing provisions in Subchapter N and Chapter 3 of the Code applicable. Due to the fact that H.R. 13103, however, does not limit itself to the revision of rules within these mentioned areas of the Code, but also proposes changes of provisions that fall outside of Subchapter N and Chapter 3 (for example, section 542 relating to personal holding companies), it seems likely that it was not intended to restrict the application of this new section 896 to Subchapter N and Chapter 3. Moreover, other Code provisions outside of this area which are changed by this bill, such as section 245 relating to the dividends received deduction, could not be applied reasonably in their revised form if other related rules such as section 861(a)(2)(B) are applied in their present form. For these reasons, we respectfully suggest that section 896 be appropriately amended.

3. H.R. 13103 proposes to add a new subsection (c) to section 2104 of the Code which refers to "debt obligations *owned* by a nonresident alien." This should be contrasted with the language of section 2104(a) dealing with the situs of stock "owned *and held* by a nonresident alien." As it seems doubtful that it was in-

BEST AVAILABLE COPY

tended to attract different meanings to these two subsections, we respectfully suggest a conforming amendment.

4. Similarly, H.R. 13103 and a new subsection b to section 2105 of the Code and a new subsection D to section 861 exempting "deposits with a foreign branch, * * * If such branch is engaged in the *commercial* banking business * * *" from U.S. estate and income taxation. As the present subsection 2105(b) simply requires that the money be deposited with any person "carrying on the banking business", it is not clear whether any change was intended by this new language. The Report of the Committee on Ways and Means is silent in this respect.

5. According to the proposals of H.R. 13103 the revised section 952(b) of the Code would include in Subpart F income an "effectively connected" item of income "exempt from taxation (or * * * subject to a reduced rate of tax) pursuant to a treaty obligation of the United States." In view of the fact that a number of U.S. tax treaties, e.g. U.S. tax treaties with the United Kingdom, Germany and Switzerland, subject income from real property to reduced tax rates both because the statutory rate may be reduced and because the effective rate may be lowered by changing the tax base from gross to net income, and in view of the possible election under section 871(d) and 882(d), this type of income would still fall within the ambit of Subpart F. As there is no apparent reason for this discrimination, it seems probable that it was not intended to except this category of income from the Subpart F exclusion. If this assumption is correct, another reference would have to be added to section 952(b) such as: "Subpart F income also does not include income from real property for which an election is made under section 871(d) or 882(d) or which is subject to net income taxation under a comparable provision in any treaty of the United States."

6. According to the Report of the Committee on Ways and Means (p. 1), H.R. 13103 is intended to revise systematically the U.S. tax treatment of nonresident aliens and foreign corporations. For this reason the meaning of section 872(b)(1) and (2) as well as section 883 should be clarified with respect to the "reciprocity" requirement in view of the fact that two possible criteria are applicable, namely, (a) place of incorporation (or perhaps fiscal residence of a corporation) and (b) place of documentation. The ambiguous state of the present law can best be illustrated by the following example, which assumes that foreign corporation A owns ships documented under the laws of country X and country X grants a tax exemption to U.S. corporations with respect to income from the operation of ships documented in the U.S. As applied to these facts, it is not clear whether section 883 provides that the U.S. on the basis of reciprocity will grant an exemption to corporation A only if A is incorporated under the laws of X or regardless of where it is incorporated? Furthermore, Congress should review the policy objectives of these provisions and then determine how the U.S. would interpret the reciprocity concept if country X in our above example were, for instance, to expand the exemption it grants to U.S. corporations to cover income from the operation of ships regardless of where documented. Would the U.S. want to reciprocate by granting an exemption to corporation A regardless of where it is incorporated or would it rather deny any exemption to corporation A on the theory that the U.S. only wants foreign countries to exempt U.S. corporations with respect to income from the operation of ships documented in the U.S.? Based on present law, these questions cannot be satisfactorily answered so that we respectfully suggest that Congress use this opportunity to clarify these problems.

7. Finally, it is submitted that section 864(b)(2)(A)(ii) should be redrafted so that the statute itself explicitly clarifies the tax treatment of foreign investment companies having their principal office within the U.S. This would make it unnecessary to refer to the legislative history which, at present, is the only source dealing with this problem.

II. SUGGESTIONS FOR SUBSTANTIVE CHANGES IN H.R. 13103

1. *"Effectively connected" concept*

H.R. 13103 introduces the new concept of "effectively connected" income as a means to—

(1) distinguish between business and investment income, and

(2) determine the amount of business income that is subject to the regular progressive U.S. tax rates.

According to the legislative history of this bill, the first purpose was to encourage foreign investment in the U.S. by having investment income taxed at only 30 per cent (or the lower applicable treaty rate) whether or not the foreign owner is engaged in business in the United States. The second purpose was to prevent abuse of the American source rules by foreign corporations which use the U.S. as a tax haven.

An analysis of the origin of the "effectively connected" concept reveals that this is no term of art. This expression, which did not appear in any of the Model Tax Conventions of the Fiscal Committee of the League of Nations, was apparently used for the first time in art. 10, para. 4, art. 11, para. 4 and art. 12, para. 3 of the Draft Double Taxation Convention on Income and Capital of 1963 prepared by the Fiscal Committee of the Organization for Economic Cooperation and Development (OECD). In recent times this expression has also been used in the income tax treaties of the U.S. with Germany, the Netherlands and the United Kingdom in connection with the allocation of earnings and profits to a permanent establishment.[1]

It appears that the expression "effectively connected" is the English translation of the prevailing European concept concerning the attribution of dividends, interest and royalties to a permanent establishment. This is confirmed by the fact that the OECD Draft Convention, which first made use of this term and predominantly reflects the views of its European members states, also employs this concept for delimiting certain categories of income, namely, dividends, interest and royalties to be attributed to a permanent establishment. If such dividends, interest and royalties are not "effectively connected" with the permanent establishment and, therefore, do not constitute "business profits" of the permanent establishment within the ambit of art. 7 of the OECD Draft Treaty, they are not taxable in the state in which they arise (i.e. in the state of the permanent establishment) but rather in the state of the recipient. This same rule is also to be found in the U.S. income tax treaties with Germany and the United Kingdom.

In the light of this historical background it appears that H.R. 13103 proposes to incorporate the existing treaty law with regard to the distinction between business and investment income into domestic tax law. This transposition is apt to cause increased complexities because of its effect upon the traditional source rules in the U.S. Code. The distinction between business and investment income means that one type of income, e.g. royalties, may have two different sources depending upon whether in the particular facts it is business income effectively connected with a permanent establishment or investment income not effectively connected with a permanent establishment. It is this relation to the traditional source rules that could lead to unnecessary theoretical and practical difficulties. Such difficulties may arise if the provisions of H.R. 13103 according to which the President may under certain circumstances cancel the benefits of this bill prove effective in causing other countries to adopt this system of taxing foreigners. Thus it is conceivable that two foreign countries might tax someone who is a "foreigner" as to both of those countries on the same income. For example, the royalty income of a U.S. citizen may be taxed by France and Switzerland because it has its source in France as business income of a permanent establishment in France and also has its source in Switzerland as investment income paid by a resident of Switzerland. If this occurs, double taxation can only be avoided, if France agrees to adopt something like a sect. 906 credit which is unlikely in view of its present tax system.

In addition, it is hard to understand why H.R. 13103 limits the application of the "effectively connected" concept to three specific types of foreign source income, namely rents and royalties, dividends and interest derived in the active conduct of a banking or similar business and certain sales income attributable to a U.S. sales office.

In the interest of maintaining a logically structured tax system, we therefore recommend that Congress abolish the "effectively connected" concept altogether or else at least limit its application to U.S. source income. It should then consider possible changes in the domestic source rules with regard to dividends, interest, royalties and sales income. In this respect it is to be observed that the Report of the Ways and Means Committee does not explain why these source rules cannot be revised so as to prevent their present abuse. One such revision, for instance, might be to substitute the "destination" test for the

[1] Cf. art. 6, para. 7; art. 7, para. 3; art. 8, para. 4; and art. 16A, para. 2 of the treaty with Germany, art. 7, para. 3; art. 8, para. 2, and art. 9, para. 3 of the Suppl. Prot. of December 30, 1965, to the treaty with the Netherlands; art. 6, para. 4 and 5; art. 7, para. 3 and art. 8, para. 3, of the Suppl. Prot. of March 17, 1966, to the treaty with the United Kingdom.

present "passage of title" test in the case of sales income. Such a change would not only present abuse of the source rules but would also favor exports and discourage imports thereby alleviating to some extent the present balance of payments problem.

Another objection against the "effectively connected" concept is that it provides no answer to the question whether a foreign corporation could be engaged in more than one "trade or business". If, for instance, a foreign corporation selling merchandise to other foreign countries through a U.S. sales office is deemed to have realized sales income "effectively connected" with its U.S. place of business and at the same time also earns U.S. source service income through another one of its U.S. offices, it is not clear whether H.R. 13103 would allow the separate taxation of income from each "business activity", or require an aggregate taxation of both the sales and services profits.

Apart from the above-mentioned objections, which alone would justify the elimination of the "effectively connected" concept, the practical application of this concept also presents formidable difficulties. Due to the fact that this concept had its origin in various international tax treaties which have been in existence for some time, it was possible for the Report of the Ways and Means Committee to lay down rather specific guidelines, which presumably would be incorporated in regulations, for determining when U.S. source income would be "effectively connected" with a business and when it would be derived from investments. By contrast, it apparently was not possible for the Ways and Means Committee to lay down guidelines for application of the "effectively connected" concept to foreign source income. This may be due to the fact that there is to our knowledge no other tax system which allows the "effectively connected" concept to supersede or conflict with domestic source rules. This in turn may be the reason why the Committee Report limits itself to the statement (p. 63) that one or another factor alone will not suffice to subject certain foreign source income to U.S. taxation and failed to give any general rules that could serve as guidelines for future judicial or administrative interpretation. This, of course, makes it impossible to foresee the future implications of this concept to foreign source income.

For these reasons it is respectfully submitted that the "effectively connected" concept should be eliminated from H.R. 13103 altogether, or at least limited in its application to U.S. source income. Under no circumstances should it be permitted to conflict with or supersede traditional U.S. source rules which could well be amended to prevent abuses from the use of the U.S. as a tax haven.

2. Taxation of interest paid on deposits of foreigners

H.R. 13103 would subject currently exempt interest on U.S. bank deposits of nonresident aliens and foreign corporations to U.S. income taxation. Such tax would go into effect on January 1, 1972, and would be collected by withholding at source.

Legal, economic and administrative considerations militate against the enactment of this provision. The Report of the Ways and Means Committee states that the primary reason for the proposed change of this source rule was "that it is questionable whether interest income of this type, which is so clearly derived from U.S. sources should be treated as though derived from sources without the U.S. and thereby escape U.S. taxation" (Report p. 7). In view of the fact that the majority of the developed European Countries, such as France,[2] Holland,[3] Sweden[4] and the United Kingdom,[5] which play an important role in the capital markets of the world, do not impose similar taxes, there is an overriding economic argument against the tax, namely, that of a free flow of capital. There can be no doubt that the enactment of this proposed provision would create a barrier against the inflow of capital into the U.S. and encourage the withdrawal of substantial bank deposits from this country. It seems strange for the United States, with its serious balance of payment deficit, to change a long existing source rule which now conforms to that of many of the developed countries of the world, for purely formalistic reasons.

Furthermore, such a change does not even seem justifiable from an equitable point of view as there is no reason why residents and citizens should be treated in the same manner as nonresident aliens since they do not receive the same measure of benefits from the United States government.

---

[2] World Tax Series, Taxation in France, p. 753 and chapt. 9/1.2e.
[3] Amended Income Tax Law of 1941, Part V, Chapt. 1.
[4] World Tax Series, Taxation in Sweden, chapt. 11/4.10, p. 487.
[5] Revenue Act 1952.

By imposing this proposed tax the average net return on U.S. bank deposits owned by foreign corporations and nonresident aliens will be reduced by 30 per cent (or lower applicable treaty rate). If the tax were to be 30 per cent, the return on the deposits in the U.S. would equal about half of the return that could be earned on the European Euro-dollar market. This fact, as well as the loss of secrecy due to the information requirements that are necessarily connected with the imposition of a withholding tax, will undoubtedly drive a great number of foreign investors out of U.S. banks and into the hands of foreign institutions, a development which is neither in the international interest of the balance of payments nor in that of the domestic U.S. economy.

Although the delay in the effective date of this provision would alleviate the problem, it is to be expected that new U.S. bank deposits of foreigners would be greatly reduced and that existing deposits gradually withdrawn because of this provision. Whether the withdrawn funds would reappear in other forms of U.S. investments is highly speculative. Certainly the proposed tax would be an important unfavorable factor in our balance of payments problem.

Finally, H.R. 13103 would require U.S. banks, acting as withholding agents, to determine whether or not the interest they would pay on foreign owned deposits would be "effectively connected" with the U.S. business of the depositor. Not only would this requirement impose an extremely heavy administrative burden on U.S. banks but it would necessitate their clerical staff to pass upon an intricate and difficult legal question exceeding their professional capabilities, or obtaining expensive legal opinions. Furthermore, it seems doubtful whether these banks would be able to collect the necessary factual data to enable them to reach a decision in a specific case.

There can be no doubt, therefore that this proposed change of U.S. source rules is neither necessary nor justified, but on the contrary would cause severe economic damage to the economy of this country.

3. Estate taxation of foreign bank deposits

In addition to taxing the interest paid by U.S. banks on deposits of nonresident aliens and foreign corporations, H.R. 13103 if enacted would subject such deposits to the U.S. estate tax.

In view of the fact that this bill was originally intended to encourage foreign investment in the U.S., it is difficult to understand why this provision is included in the bill. As contrasted with the postponement of the effective date of the income taxation of interest on U.S. bank deposits of foreigners (to avoid an immediate adverse effect on the balance of payment problem) the estate tax on such bank deposits would go into effect immediately upon the enactment of this bill. This immediate effect would at least neutralize any advantages resulting from the delay in the income taxation of the interest on bank deposits. Most foreign investors who will be looking for new investment possibilities for the period after 1971 would certainly not be willing to run the risk of being subject to the estate tax during this transitional period. It would be desirable, therefore, to eliminate this provision.

4. Net taxation of nonresident alien individuals

H.R. 13103 finally provides for a flat 30 per cent withholding tax on the investment income of nonresident aliens and also gives such taxpayers the option of elected to be taxed on a net basis with regard to their income from real property. Apart from the fact that it seems difficult to justify taxing the income of nonresidents at a higher rate than that of people living in this country who enjoy the benefits of citizenship and residence, there also seems to be little merit in limiting the optional net taxation of nonresident alien individuals to real property income. For these reasons we respectfully suggest amending H.R. 13103 so that nonresident alien individuals could elect to have all their U.S. source income taxed on a net basis. This amendment would furthermore be consistent with the present withholding system on all fixed or determinable income and all other income described in section 1441 (a) and (b) of the Code inasmuch as it would require the affected taxpayer who wished to be taxed on a net base to apply for a refund. In addition, the newly created section 896 providing for reinstatement of present rules if a foreign country proves recalcitrant could always serve as a means of avoiding any unfavorable effects of such a provision.

CLARK EQUIPMENT CO.,
Buchanan, Mich., August 5, 1966.

Subject: H.R. 13103 ("Foreign Investors Tax Act of 1966").

Hon. RUSSELL B. LONG,
Chairman, Senate Committee on Finance,
Senate Office Building, Washington, D.C.

SIR: I am taking this opportunity to protest to you certain provisions currently incorporated in H.R. 13103 ("Foreign Investors Tax Act of 1966") which is now before your Committee for consideration and recommendation.

I would first call to your attention the language found in Sec. 2, subsection (d) paragraph (4), subparagraph (D) of such Bill (beginning on page 16, line 16 of the June 16, 1966 printing of H.R. 13103) as follows:

"(D) No income, gain, or loss from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States if it * * *

(ii) is subpart F income within the meaning of section 952(a)."

In analyzing such exclusion from the "effectively connected" income category, House Report No. 1450 states, at page 68 thereof:

"Clause (ii) of subparagraph (D) provides for the exclusion of any income from sources without the United States which is subpart F income within the meaning of section 952(a) of the code. Under that section a foreign corporation can have subpart F income only if it is a controlled foreign corporation within the meaning of section 957. In general, the subpart F income of a controlled foreign corporation is includible in the income of its shareholders who are U.S. shareholders within the meaning of section 951(b). However, exceptions to this general rule are provided by sections 951 (c) and (d) and 963 of the code * * *. However, income of a controlled foreign corporation *will not be considered subpart F income* for purposes of clause (ii) of subparagraph (D) *if it is excluded from subpart F income by any provision of subpart F of part III of subchapter N of chapter 1 of the code.*" (My emphasis.)

Insofar as the above-quoted language might be construed to exclude from the relief of clause (ii) of said subparagraph (D) sums excluded from gross income "with respect to the subpart F income of a controlled foreign corporation" by reason of its making an appropriate minimum distribution pursuant to the provisions of Section 963 of the code (found in subpart F of part III of subchapter N of chapter 1 of the Code), it is respectfully requested that your Committee clarify the intent of the Congress as to the applicability of clause (ii) of said subparagraph (D) to a Section 963 situation.

I would, at this time, respectfully submit that income which is otherwise subpart F income should not lose its character as such merely because of a minimum distribution under section 963, and the Congress should not allow the well reasoned and appropriately based relief extended to U.S. shareholders by section 963 of the Code to be effectively extinguished by permitting a harsh and unduly rstrictive interpretation of clause (ii) of said subparagraph (D) to be adopted.

Were such an interpretation to be permitted, a situation might well develop wherein a controlled foreign corporation made a minimum distribution of say 100% of its earnings and profits only to find that it has a tax liability due and owing to the Federal Government.

Moreover, with respect to the same above-quoted language it is submitted that the following language of section 954(b)(4) of the code should not be deemed to exclude from the relief provision of clause (ii), of said subparagraph (D), income which would otherwise be characterized as subpart F income:

"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, or excess profits taxes or similar taxes."

Were such a limitation not placed upon the use of section 954(b)(4), a controlled foreign corporation would be placed in the dilemma of possibly making a minimum distribution of, say, 100% of its earnings and profits only to find that the Secretary or his delegate has determined that a certain item or items of income of such controlled foreign corporation do not constitute foreign base company income—as with respect to such item or items of income the creation of the controlled foreign corporation does not have the effect of a substantial reduction of income taxes (i.e., such income will be taxed as income "effectively connected w.th the conduct of a trade or business within the United States" and thus such controlled foreign corporation has an outstanding tax liability due and owing to the Federal Government). Indeed, one wonders whether all "effectively connected" income couldn't be excluded from foreign base company income under the above theory, merely at the discretion of the Secretary or his delegate so as to completely nullify the relief granted by the Congress in clause (ii) of said subparagraph (D) or at least subject the availability of such relief to the discretion of the Secretary or his delegate.

The minimum distribution provisions of section 963 of the code were carefully drafted in an effort not to penalize legitimate U.S. investment abroad which seeks to repatriate—and not hoard—foreign income earned on such investments. Insofar as the provisions of clause (ii) of said paragraph (D) are susceptible to an interpretation which would penalize and/or make uncertain and confusing the status of such legitimate U.S. investments abroad, it is respectfuly requested that your Committee act to reaffirm the Congressional intent in this area. Certainly the relief provisions of section 963 of the code have proven themselves to be the guiding light for legitimate U.S. investments abroad in this highly complex and sometimes dimly lit area of our Federal tax structure. The relief provisions of section 963 of the code should not be permitted to become ineffectual or circumscribed by this Bill.

The following language is submitted for your consideration as a possible amendment to the Bill by inserting as an addition thereto immediately after said subparagraph (D) the following language:

"(E) In determining what constitutes subpart F income for purposes of (D)(ii) above, neither the provisions of section 963 of the code nor the provisions of section 954(b)(4) of the code shall be deemed to exclude any income from being characterized as subpart F income."

A second major problem area involves the unnecessarily restrictive provisions relating to an "overseas operations funding subsidiary" found in subsection (C) of section 6 of the Bill (beginning on page 68, line 9, of the June 16, 1966, printing of H.R. 13103). Thus, in compliance with requests by the President of the United States and the Secretary of Commerce to voluntarily aid in alleviating an adverse balance of payments situation, Clark Equipment Company recently organized a wholly owned domestic subsidiary for the purpose of raising necessary funds abroad to finance the expanding operations of foreign affiliated corporations. Such newly formed corporation sold $15,000,000 worth of debentures in Europe to raise the necessary investment capital. Pursuant to oral instructions from I.R.S. staff personnel, a request for necessary tax rulings stated that such newly organized subsidiary planned to invest at least 85% of the proceeds from the sale of the aforementioned debentures in stock or debt obligations of foreign corporations in which Clark owned or would own *10% or more* of such corporations' total combined voting power at the time of the investment. It is my understanding that this language was also given other U.S. corporations setting up similar foreign financing subsidiaries by personnel of the I.R.S.

Now, however, despite the verbal direction given United States taxpayers by representatives of the Internal Revenue Service, paragraph 1 of subsection (c) of section 6 of H.R. 13103 adds to the type of interest which is excluded from the special per country foreign tax credit limitation prescribed by section 904(f)(3) of the code, interest received by an "overseas operations funding subsidiary" on obligations of a "related foreign corporation." Paragraph 2 of subsection (c) of section 6 of the bill then defines the term "overseas operations funding subsidiary" as a domestic corporation which (i) is a member of an affiliated group within the meaning of section 1504 and is not the common parent corporation of such group, and (ii) *was formed AND is availed of* for the principal purpose of raising funds outside the United States through public offerings to foreign persons and of using such funds to finance the operations in foreign countries of one or more related corporations. A "related foreign corporation" is then defined as a foreign corporation owned *50% or more* by the affiliated group of which the "overseas operations funding subsidiary" is a member, either directly or through the ownership of the voting stock of *another* foreign corporation.

Thus, it would appear that the "principal purpose" test must be met on two occasions: (1) the time such overseas operations funding subsidiary was formed and (2) during the current operations of such overseas operations funding subsidiary. If the "principal purpose" test was thus to be strictly applied to Clark Equipment Company and similarly situated United States corporations which have already acted in response to the call for voluntary action made by the Administration and within the guidelines then promulgated by the Internal Revenue Service, such corporations may be deprived of standing as an "overseas operations funding subsidiary" in that their stated principal purpose for being formed was to finance *10% or more* owned foreign affiliated companies and *not* 50% or more owned foreign affiliated companies as the proposed legislation requires. It is respectfully submitted that those United States corporations which were quick to respond to the pleas of our Administration in regard to limiting the outflow of U.S. dollars abroad should not now be penalized for the celerity of their response.

Moreover, it should be noted that in the absence of the "overseas operations funding subsidiary" exclusion set forth in H.R. 13103, the interest received by corporations which generally meet those prescribed characteristics could be said to have been previously excluded from the separate per country limitation by the language already contained in section 904(f)(2)(B) as a corporation receiving interest "derived in the conduct of a banking, financing or similar business." With the enactment of H.R. 13103 the general rules of statutory construction would appear to require the conclusion that the Congress, by creating an additional exclusion encompassing interest received by an "overseas operations funding subsidiary" was acting to fill a void and that corporations generally meeting the definition of an "overseas operations funding subsidiary" must thus look to the requirements of that exclusion for relief or come within the per country limitation of section 904(f)(3).

To correct this apparent inequity it is suggested that the 50% figure used on page 69, line 19 of the Bill should be deleted and the figure 10% inserted in lieu thereof. Such change would tend to equate the relief provisions granted an "overseas operations funding subsidiary" with the relief provisions already found in section 904(f)(2)(C) which deletes from the per country limitation "interest received from a corporation in which the taxpayer owns at least 10% of the voting stock."

As previously stated, a "related foreign corporation" is defined as a foreign corporation owned 50% or more by the affiliated group of which the "overseas operations funding subsidiary" is a member, either directly or through the ownership of the voting stock of "another" foreign corporation. Thus, a "related foreign corporation" is by definition restricted to a first or second-tier foreign corporation. It is respectfully submitted that this restrictive definition should be liberalized by deleting "another foreign corporation" on page 69, line 22 of the Bill and inserting in lieu thereof the phrase "one or more other foreign corporations."

Very truly yours,

CLARK EQUIPMENT CO.,
By R. F. SUMERWELL, *Tax Manager.*

MACHINERY & ALLIED PRODUCTS INSTITUTE,
Washington, D.C., August 1, 1966.

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

DEAR SENATOR LONG: We have just learned of the Finance Committee's plans to hold public hearings on H.R. 13103, the proposed Foreign Investors Tax Act. This bill is of very considerable interest and concern to a number of members of the Machinery and Allied Products Institute, a national organization of capital goods and allied product manufacturers with extensive foreign operations.

Consistent with your invitation for the submission of written statements respecting this bill, we have set out herein a statement of our suggestions and recommendations for amendment and clarification of H.R. 13103 and ask that it be included in the printed record of the hearings.

67-485—66——18

SOME GENERAL OBSERVATIONS

It is our conviction that there would be an adverse economic impact from application to foreign source income of the proposed "effectively connected" concept.

Under Section 2(d) of the bill, rental and royalty income derived by a foreign corporation from the use outside the United States of patents, copyrights, trademarks and other intangible property, and attributable to an office or other fixed place of business in the United States would be deemed to be "effectively connected" with the conduct by the foreign corporation of a trade or business in the United States and consequently subject to U.S. taxation even though such income is also deemed to be derived from foreign sources. The same rule would apply to sales income attributable to a U.S. business location of the foreign corporation; however, such sales would not be deemed "effectively connected" if the goods in question are sold for use, consumption, or disposition outside this country, *and* an office or other fixed place of business of the foreign corporation outside the U.S. "participated materially" in the sale. The bill would include any foreign corporation without regard to its ownership—thus it would cover foriegn corporate subsidiaries of American parent companies.

The basic purpose of this legislation, at least in its initial stages, was to stimulate foreign investment in the United States. The subsequent addition of the "effectively connected" concept and its application to extend U.S. taxation to certain foreign source income of foreign subsidiaries of U.S. companies, is, we submit, unrelated to this legislative objective and, moreover, it is incompatible with a number of other basic national economic objectives. There are many instances when it is desirable for commercial nontax reasons relating to the expansion of foreign markets to establish a U.S. business location for the foreign subsidiary or to have certain functions connected with this foreign business performed by parent company personnel located in the United States. To the extent that this legislation permits U.S. taxation of income from the use of patents and trademarks abroad and income from the sale of goods used or consumed abroad, it is obviously a deterrent to expansion of this type of foreign business. Thus, it hinders the basic governmental policy of strengthening the overall U.S. position in respect to the international balance of payments.

There are a number of ways in which this problem can be ameliorated. One would be to insert a proviso in the bill that its separate provisions are not to be construed in such a way as to either impose a U.S. tax liability when none has existed in the past or increase an already existing tax. Another alternative, already suggested to the Ways and Means Committee, would be to provide that the "effectively connected" provisions are not to apply to foreign source income of a foreign corporation when the latter is a "controlled foreign corporation" under Subpart F of the Internal Revenue Code, that is, when it is a foreign subsidiary of a U.S. company.

In addition to these fundamental methods of insuring that application of the "effectively connected" concept does not injure American business abroad, we have some additional suggestions relating to the specifics of Section 2(d) of the bill. The parenthetical references indicate provisions of the Internal Revenue Code which would be affected by Section 2(d).

PERFORMANCE OF NONMANAGEMENT TASKS BY THE U.S. PARENT COMPANY (CODE SECTION 864(C) (4) (B))

The Ways and Means Committee report on the bill makes it clear that a foreign subsidiary will not be deemed to have a business location in the United States merely because its U.S. parent company exercises general supervision and control over the policies of the subsidiary.[1] We note, however, that under Example (3) following the statement of this general rule in the report, if orders received by the subsidiary are subject to review by an officer of the parent company before acceptance, the subsidiary will be deemed to have a business office in the United States. Such a review policy is a common operating practice—and good business practice—with respect to orders received by a foreign subsidiary and we think it is perfectly compatible with the exercise of "general supervision and control" by the parent company. We urge that Example (3) be amended to conform with this interpretation.

[1] House Report No. 1450, 89th Congress, 2d Session, p. 63.

In addition, the "general supervision and control" rule needs to be broadened so that it would clearly not affect the performance by parent company personnel of services for the subsidiary that might be deemed to be nonmanagement in nature (e.g., clerical services). We think that when (as is normally the case) the performance of such "nonmanagement" services is clearly only a minor or incidental part of the parent company's overall activity with respect to the subsidiary, the subsidiary should not be deemed to have a business location in the United States.

RENTS OR ROYALTIES (CODE SECTION 864(C)(4)(B)(i))

This provision, as amplified in the report, would permit rents and royalties to be "effectively connected" with the United States if a business location of the foreign subsidiary in this country "either actively participates in soliciting, negotiating, or performing other activities required to arrange, the lease or license * * * or performs significant services incident to such lease or license."[3]

It is clear then that U.S. tax can be imposed even though the lease or license arrangements are negotiated from a foreign business location of the foreign subsidiary so long as the U.S. business location is deemed to have performed "significant" services incident to the lease or license. It seems to us that this provision is unsound because it would permit U.S. taxation in cases where the activities of the U.S. business location, even though admittedly "substantial," are obviously subordinate to or minor in comparison with the activities performed by the foreign business location with respect to the lease or license. This provision should be amended to provide that U.S. tax will not be imposed so long as a foreign business location of the subsidiary or of a related company "participates materially" in the activities relating to the lease or license.

SALES INCOME (CODE SECTION 864(C)(4)(B)(iii))

As noted earlier, sales income of a foreign subsidiary which is deemed to have a U.S. business location may be considered "effectively connected" unless the goods in question are sold for use, consumption, or disposition outside this country, *and* a foreign business location of the subsidiary has "participated materially" in the transaction.

This provision seems to us more logical than the related provision respecting rental and royalty income because it would exempt the sales income from U.S. taxation providing there is material participation by a foreign business location of the subsidiary in the transaction. However, there is a problem which we think should be corrected; this relates to multiple foreign subsidiaries. In many cases, a capital goods manufacturer in this country will have one foreign subsidiary take care of the sales transaction itself while another subsidiary is charged with the responsibility of providing necessary services in connection with that sale. There is no question that, as a practical matter, a foreign business location of the foreign sales operation (considered as a whole) has materially participated in the sales transaction. Yet the bill, as currently worded, would exempt sales income only if the material participation abroad is by a foreign business location of the foreign subsidiary which is deemed to be doing business in the United States. We suggest that this might be corrected by providing for exemption when there is material participation in the sales transaction by a foreign business location of the subsidiary *or* a related corporation.

EXCLUSION FOR SUBPART F INCOME (CODE SECTION 864(C)(4)(D)(II))

The bill would exempt from the reach of the "effectively connected" concept any income of the foreign subsidiary which is deemed to be Subpart F income within the meaning of Code Section 952(a). A question arises as to whether this exclusion would also apply to foreign subsidiary income which would be considered Subpart F income but for the operation of one or more of the exclusions to Subpart F itself, such as, for example:

1. A minimum distribution under Code Section 963;
2. Export trade income under Code Section 970;
3. Foreign base company income which constitutes less than 30 percent of the total gross income of the foreign subsidiary; and

[3] *Ibid.*, p. 64.

4. Foreign base company income when it is established, with respect to that income, that the organization of the foreign subsidiary does "not have the effect of substantial reduction [of taxes]."

We think that the reasons for these specific exemptions from Subpart F were considered at great length by Congress during its prolonged deliberation on the Revenue Act of 1962 and we feel that it would be most unwise to change these decisions and now permit the use of the proposed "effectively connected" concept to reach such items of income. Accordingly, we urge that the Subpart F exclusion included in the bill be amended to make it clear that it applies to all Subpart F income and also income of the foreign subsidiary which would be considered Subpart F income but for one or more of the exclusions contained in Subpart F itself.

This concludes our comments on the "effectively connected" concept included in the proposed Foreign Investors Tax Act. We appreciate this opportunity of commenting on H.R. 13103. If the Institute or its staff can be of further assistance in the Committee's consideration of the bill we trust that you will not hesitate to call on us.

Respectfully,

CHARLES I. DERR,
Senior Vice President.

WILLKIE FARR GALLAGHER WALTON & FITZGIBBON,
New York, N.Y., July 11, 1966.

Re Foreign Investors Tax Act of 1966 section 2(d)(2).

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

SIR: I am writing to you concerning the Foreign Investors Tax Act of 1966. More specifically I am concerned with section 2(d)(2) of the Act which adds proposed new section 864(b)(2) to the Internal Revenue Code. This new section of the Internal Revenue Code would permit a taxpayer who is not a dealer in stocks or securities to trade in stocks or securities for his own account directly or through an employee or a discretionary agent located in the United States without being treated as being engaged in a trade or business in the United States. The House Ways and Means Committee report indicates that this proposed amendment of the Internal Revenue Code is intended to amend section 871(c) of the Code and expand the scope of activities in the United States in which a foreign taxpayer trading in stocks or securities may engage without being classified as being engaged in trade or business in the United States.

As section 2(d)(2) of the Act now stands, it applies to a "taxpayer" trading for taxpayer's own account. I believe that the use in the section of the term "taxpayer"—i.e., a person subject to internal revenue tax (I.R.C. § 7701(a)(14))—unduly and probably unintentionally, restricts the application of the provision. Thus, for example, if a nonresident alien individual were a limited parter in a partnership whose only activity in the United States involved trading in stocks or securities, the new provision would not apply to that individual since trading in stocks or securities did not take place for the taxpayer's own account, but rather for the partnership's account. This produces the rather anomalous result that a nonresident alien individual who is a limited partner in a partnership trading in stocks or securities may be considered to be engaged in a trade or business in the United States because of the partnership's trading activities in the United States, although he, as a limited partner, cannot even participate in the trading activities of the partnership; in contrast, that same nonresident alien individual could be personally present in the United States or have an employee or discretionary agent here and not be considered to be engaged in a trade or business in the United States because of the trading activities carried on by the taxpayer, his employees or his agents.

Not only is this result anomalous, but I believe it may operate to deter some foreign investment in the United States by foreign investors who want to invest in United States' securities and derive the benefits of diversification of investment and professional management which an investing partnership can produce. I represent several persons who are presently engaged in forming a partnership, which includes a substantial number of foreigners, for the purpose of investing in United States stocks and bonds. My clients have found that a great many foreign investors have indicated a desire to be able to be investors in such a limited partnership, and my clients believe that use of this type of investment vehicle will be very attractive to potential foreign investors.

I would respectfully suggest that section 2(d)(2) of the Foreign Investors Tax Act of 1966 could be amended so as to solve the problem which I have raised by use of the term "person"—i.e., an individual, a trust, estate, partnership, association, company or corporation (I.R.C. § 770(a)(1))—in place of the term "taxpayer." Alternatively, I would suggest that the section of the Act could be amended by adding the following sentence as clause (iii) in proposed section 864(b)(2)(A):

> (iii) Except in the case of a partnership which is a dealer in stocks or securities, in the case of a limited partner, trading in stocks or securities for the partnership's own account by the partnership or through a resident broker, commission agent, custodian or other agent, and whether or not any such agent has discretionary authority to make decisions in effecting the transaction.

I would very much appreciate your consideration of the matters raised in this letter. If I may be of any assistance to you in obtaining additional information for you as to the points raised, please communicate with me. I would also appreciate being notified as to when Committee on Finance hearings are scheduled to commence on the Foreign Investors Tax Act of 1966.

Very truly yours,

THOMAS N. TARLEAU.

WILLKIE FARR GALLAGHER WALTON & FITZGIBBONS,
New York, N.Y., August 10, 1966.

Re Foreign Investors Tax Act of 1966, section 2(d)(2).

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

DEAR SENATOR: I have received your letter of August 1, 1966 inviting me to testify before your Committee. Although I am unable to personally appear, I would like to take this opportunity to communicate to you some comments on the proposed legislation. I had previously written to you on July 11, 1966 with respect to the proposed legislation.

I am especially concerned about the unfortunate, and perhaps unintended, effect of Sec. 2(d)(2) in view of stated Congressional design to encourage, by introduction of the Foreign Investors Tax Act of 1966, the investment of foreign capital in this country with consequent improvement in the balance of payments. Sec. 2(d)(2), which adds proposed Sec. 864(b)(2) to the Internal Revenue Code, would permit a non-resident alien other than a dealer in stocks and securities to grant discretionary authority to a United States broker or other agent to carry out transactions in the United States with respect to stocks, securities or commodities without the non-resident alien being considered engaged in carrying on a trade or business in this country. Under present law the granting of such discretionary authority would expose the non-resident alien to tax on grounds of doing business.

Section 2(d)(2) of the proposed Act applies to a "taxpayer" trading for his own account in the United States through an employee or agent in the United States who may or may not have discretionary authority. It seems to me that the proposed legislation unnecessarily and inequitably inhibits the attraction of foreign capital by restricting the change in the law to a taxpayer trading for his own account. In general, a foreigner who desires professional management of his money in United States securities has two operating vehicles available, namely, to give an agent in the United States discretionary authority to buy and sell, or to become a limited partner in a domestic private investment partnership. In such a partnership the general partners are professional money managers, and the limited partners are, in effect, investors. The limited partnership route is similar in nature to the agent who has broad discretionary power in terms of achieving the desired effect of professional personnel managing funds; however, a foreigner who wishes to invest substantial sums of money may desire the private investment partnership route for the following reasons:

1. It affords the foreigner greater diversification of risk since his money is being pooled with monies of other limited partners to purchase a bigger and more diversified portfolio.

2. The general partners, who manage money in much the same way as the private agent with broad discretionary powers, have greater market leverage and may be able to obtain better brokerage services and advice since more money is available on a pooled basis.

3. Since a private investment partnership would be the receptacle for larger amounts of money than the private agent might attract, the company can afford to retain more and better professional managers.

4. A discretionary agent is necessarily limited as to the number of separate accounts he can efficiently manage. The pooling of funds in a limited partnership permits him to accommodate a greater number of accounts.

For the reasons above expressed, it seems to me that a domestic private investment partnership is more likely to attract and capture substantial sums of foreign capital than would the private agent with discretionary authority. Such private investment partnerships have proven popular and successful in the United States in the past fifteen years. I have been told that their total assets now approximate $250,000,000. Under current tax law, such private investment partnerships have not been able to attract foreign capital since a non-resident alien who becomes a limited partner therein would be exposed to United States tax on his allocable share of the capital gains on grounds that the trade or business of the partnership would be attributed to him. Failure to attract foreign capital is especially unfortunate since it is my understanding that foreigners are very interested in investing in private investment partnerships and would invest substantial sums if the tax laws were more accommodating.

In my opinion, there exists no reason to continue to insist that a non-resident limited partner in a private investment company is considered to be carrying on a trade or business if a non-resident alien is not considered to be engaged in the carrying on of a trade or business by the effecting of securities transactions through a domestic agent with broad discretionary powers. As indicated above, the management of money by a private investment partnership and by a private agent with discretionary power is essentially similar in nature and, if it is stated Congressional design to encourage foreign capital by liberalizing the law with respect to the private agent with discretionary power, such liberalization logically should extend to the limited partnership situation in view of the fact that the private investment partnership route is, as a practical matter, the most attractive investment vehicle for substantial sums of foreign capital.

If you agree with the above recommendation, I would respectfully suggest that section 2(d)(2) of the Foreign Investors Tax Act of 1966 could be amended so as to solve the problem which I have raised by use of the term "person"—i.e., an individual, a trust, estate, partnership, association, company or corporation (I.R.C. § 770(a)(1))—in place of the term "taxpayer." Alternatively, I would suggest that the section of the Act could be amended by adding the following sentence as clause (iii) in proposed section 864(b)(2)(A):

> (iii) Except in the case of a partnership which is a dealer in stocks or securities, in the case of a limited partner, trading in stocks or securities for the partnership's own account by the partnership or through a resident broker, commission agent, custodian or other agent, and whether or not any such agent has discretionary authority to make decisions in effecting the transaction.

Very truly yours,

THOMAS N. TARLEAU.

KAISER ALUMINUM & CHEMICAL CORP.,
Washington, D.C., August 8, 1966.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: We wish to submit for consideration a technical amendment to HR 13103, the Foreign Investors Tax Act of 1966, that is now pending before your Committee. As you know, this Act deals comprehensively with certain income and other tax aspects of foreign taxpayers, including foreign corporations in which United States investors may have a substantial interest.

Direct investment in foreign subsidiaries (that is, investment in debt obligations or stock of foreign corporations in which the U.S. parent has a voting stock interest of 10% or more) is exempt from interest equalization tax if the parent U.S. company makes the investment with no present intent to sell the security or other evidence of indebtedness. In order to provide flexibility in the manner by which U.S. companies may finance the development of foreign ores and minerals in short supply in the U.S., the Interest Equalization Tax Act also exempts under Section 4914(d) of the Internal Revenue Code—as the equivalent of direct investment—loans made by U.S. institutional lenders to foreign subsidiaries producing such ores and minerals where the financing is secured by so-called "take or pay" contracts entered into between the foreign subsidiary and the U.S. parent. However, such loans become subject to tax under Section 4914(j)(1)(a) when and if they are subsequently transferred by the lender to another person, regardless of intent at the time of acquisition.

This "recapture" of tax on subsequent transfer of indebtedness applies generally to a number of exempted transactions in order to prevent abuse of the exemptions beyond their intended purpose, which might result from a transfer to a third party lender; but it is inappropriate to apply such "recapture" to the financing of "take or pay" mineral production contracts the exemption for which contemplated that a third party lender would participate in the transaction from the outset. In fact, "recapture" in the case of the "take or pay" exemption serves to defeat the purpose of the exemption—which was intended to facilitate loans from financial institutions for purposes consistent with the raw material requirements of the United States—since such institutional lenders always acquire negotiable instruments and may in fact subsequently sell them to other lenders, even though they have no present intent at the time of acquisition to do so.

Accordingly, we respectfully suggest that Section 4914(j)(1) should be amended to provide that subsequent transfers of indebtedness originally exempted under Section 4914(d) should not be subject to tax where such indebtedness was acquired without an intent to sell it to other U.S. persons.

Respectfully,

WARD C. HUMPHREYS,
Manager, Washington Office.

THE LAREDO NATIONAL BANK,
Laredo, Tex., June 28, 1966.

Senator RUSSELL LONG,
Chairman, Senate Finance Committee,
Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: We are interested in the hearings that your committee may conduct in connection with the Foreign Investors Tax Act (H.R. 13103), and particularly the provisions of the bill which propose to impose the U.S. income tax on interest paid by U.S. commercial banks to nonresident aliens and the U.S. estate tax on deposits in U.S. commercial banks of nonresident alien individuals.

Therefore, we respectfully request that you advise us when such hearings will be conducted by your committee, and whether it will be possible for a representative of this bank to submit a written statement.

Yours very truly,

MAX A. MANDEL, *President.*

THE LAREDO NATIONAL BANK,
Laredo, Tex., April 14, 1966.

The SECRETARY OF THE TREASURY,
Washington, D.C.

DEAR SIR: I would appreciate it if you will send me a copy of H.R. 11297 referred to as the Foreign Investors' Tax Act. I understand this legislation has been proposed by the Treasury Department and provides that in the future nonresident aliens will be required to pay income tax to the United States for interest received on time deposits in U.S. commercial banks. As you know, for many years the Internal Revenue Code has specifically exempted such income from the payment of income tax.

It occurs to us that if such legislation is enacted, it will result in the withdrawal of large sums now on deposit, and obviously this will be detrimental to the United States and increase its balance of payments problem.

Kindly send me a copy of the proposed bill and a statement of the Treasury's position with respect to the legislation.

Yours very truly,

MAX A. MANDEL, *President.*

TREASURY DEPARTMENT,
Washington, D.C., April 29, 1966.

Mr. MAX A. MANDEL,
President, the Laredo National Bank, Post Office Box No. 59,
Laredo, Tex.

DEAR MR. MANDEL: This is in reply to your letter of April 14, 1966, to Secretary Fowler relating to the Foreign Investors Tax Act (H.R. 13103). Your letter expresses concern about a provision appearing in this legislation which imposes tax on interest payments made after December 31, 1971, on bank deposits of nonresident aliens and foreign corporations not engaged in trade or business in the United States.

Consideration of the proper method of taxing nonresident aliens and foreign corporations deriving income from the United States was prompted by the report of the Fowler Task Force on Promoting Increased Foreign Investment in U.S. Corporate Securities. As a consequence of this report, the Treasury Department engaged in a detailed analysis of the present system of taxing nonresident aliens and foreign corporations and submitted to the Congress legislation embodying its recommendations. This bill, H.R. 5916, was introduced on March 8, 1965, by Chairman Mills of the House Ways and Means Committee. The only change contained in H.R. 5916 relating to the taxation of bank interest received by nonresident aliens and foreign corporations was to extend the exemption now contained in the Internal Revenue Code for such interest to savings and loan associations and mutual savings banks.

The House Ways and Means Committee held public hearings on H.R. 5916 and considered the bill at length in executive sessions. In the course of its consideration, the committee was concerned with assuring the equitable tax treatment by the United States of nonresident aliens and foreign corporations. With regard to bank interest derived by foreigners from U.S. banks, the committee concluded that it was questionable whether interest income of this type, which is so clearly derived from U.S. sources, should be treated as being derived from non-U.S. sources and thereby not subject to U.S. tax. The committee, however, recognized that to eliminate the present source rule on bank deposit interest might have an adverse effect on the U.S. balance-of-payments position, and consequently, the effective date of its change was postponed until after December 31, 1971. This result is embodied in H.R. 11297 and its successor bill, H.R. 13103, which was recently reported by the committee to the House. In accordance with your request, I enclose a copy of H.R. 13103.

Thank you very much for your interest in writing on this matter.

Sincerely yours,

STANLEY S. SURREY,
Assistant Secretary.

THE LAREDO NATIONAL BANK,
Laredo, Tex., May 4, 1966.

Hon. STANLEY S. SURREY,
Assistant Secretary of the Treasury,
Washington, D.C.

DEAR MR. SURREY: I have your letter of April 29, 1966, in which you refer to the Foreign Investors Tax Act (H.R. 13103), and the fact that it results from the report of the Fowler Task Force on Promoting Increased Foreign Investment in U.S. Corporate Securities. It is my understanding that the original report did not apply to the taxation of bank interest received by nonresident aliens, and this provision was an afterthought by others.

Since 1921, Congress has recognized that it is good for this country to encourage deposits of foreign funds in U.S. banks, and this policy has continued uninterruptedly during the many years when he had no balance-of-payments problem. Now we have a real balance-of-payments problem and yet someone seems to advocate that the small amount of tax that can be generated is more important than the several billions of dollars of foreign funds that are now on deposit here. If the great majority of the funds are withdrawn, and I understand that this can be assumed, we will neither have the tax income nor the badly needed funds.

Your letter states that the House Ways and Means Committee recognizes that the new provision might have an adverse effect on the U.S. balance-of-payments position, and, for that reason has postponed the effective date of its change until after December 31, 1971. If it is admitted that the bill is harmful and its effect should be postponed, would it not be more practical and beneficial to eliminate it completely? The mere fact that serious consideration is being given to its enactment has already caused a considerable amount of anxiety among Mexicans who have deposits here now.

I will appreciate a frank statement advising just how much revenue the Treasury expects the new tax to generate, the amount of deposits of nonresident aliens and foreign corporations not engaged in trade or business in the United States presently in U.S. banks, and the amount of such deposits that will probably be lost upon the enactment of the proposed legislation.

I respectfully request that the Treasury reconsider this important legislation and convey the recommendation to the committee that it is to the best interest of the United States that the present law continue in effect.

Yours very truly,

MAX A. MANDEL, *President.*

TREASURY DEPARTMENT,
Washington, D.C., May 24, 1966.

MAX A. MANDEL,
President, the Laredo National Bank,
Post Office Box No. 59,
Laredo, Tex.

DEAR MR. MANDEL: Thank you for your letter of May 4, 1966, relating to the Foreign Investors Tax Act (H.R. 13103) and more specifically, the provision in that bill subjecting to tax interest paid by U.S. banks to nonresident aliens and foreign corporations not engaged in trade or business in the United States.

As you know, this aspect of the bill does not come into effect until after December 31, 1971. Your letter indicates that consideration of this provision by the Congress has caused considerable anxiety among foreign depositors in your bank. We would be interested in learning why foreigners would consider the withdrawal of funds from U.S. banks at this time since the provision is not to go into effect for 5 years.

We very much appreciate receiving your views on this matter.

Sincerely yours,

STANLEY S. SURREY.

THE LAREDO NATIONAL BANK,
Laredo, Tex., June 1, 1966.

Hon. STANLEY S. SURREY,
Assistant Secretary of the Treasury,
Treasury Department, Washington, D.C.

DEAR MR. SURREY: I appreciate your letter of May 24, 1966, relating to the Foreign Investors Tax Act (H.R. 13103), and I am glad to respond to your inquiry. Actually, prior to the receipt of your letter, I had an opportunity to talk in person and by telephone to a number of our Mexican customers, and I might point out that at least half of the conversations were initiated by our customers.

As you know, the matter of keeping money in a bank is one that is based on confidence and habit, and it takes many years for banks to develop long-lasting relationships. Our records show that we first began accepting savings and time accounts by the issuance of certificates of deposit around the turn of the century. At that time, our foreign customers were not numerous, but in subsequent years, particularly after World War I, our ties with Mexico began to develop, and during the past 20 years they increased at a rapid pace for a bank this size. Although Mexico is a developing nation and needs all of the savings of its people for its own expansion, you are well acquainted with the fact that many persons and corporations in Mexico, as elsewhere in Latin America, feel that it is good business for them to place some of their reserves in another country with a stable currency. It is true that at home they could receive a return of two or three times the amount they can get at our bank (our top rate on certificates of deposit at this time is 4½ percent), but they do not want to put all of their eggs in one basket, and they believe that it is prudent for them to put a portion of their reserves in a U.S. bank.

Some of our customers tell us that if the proposed legislation is enacted with the provision that the tax will not become effective until after December 31, 1971, they will not immediately draw out the money but that they will immediately begin "to look around." These were the exact words that several persons used.

Two of them pointed out that in prior years they would not have considered putting their surplus funds in any country other than the United States, but now they believe the situation is somewhat different: they are not unaware of our balance-of-payments problem, and the interest rates that they can obtain elsewhere are higher than what they can obtain in the United States. One of our customers stated that if the legislation is enacted even though the tax provision would not go into effect until a later date, it was like a "sword hanging over" his head, and he would want to move his funds as quickly as possible. One customer stated that he has already begun to look around so that he can act promptly if and when the bill is enacted. As a matter of fact, I believe that this is one of the detrimental features concerning the mere consideration of this legislation—it causes a number of people who previously were content with leaving deposits in U.S. banks to investigate alternative investments elsewhere.

We must remember that a cash deposit in a bank outside of Mexico is not the only alternative that a Mexican investor can consider. I have gained the impression, when talking to some of our customers, that they may be considering other forms of investment since they must withdraw from U.S. banks anyway. You can understand that any form of investment requires more investigation and analysis than a cash deposit, and the investor must capitalize upon an opportunity when it presents itself rather than wait for a deadline. In answer to your question, this is one of the reasons foreigners are considering the withdrawal of funds from U.S. banks at this time, even though the provision is not to go into effect for 5 years.

I realize that no one can state exactly the proportion of funds that will be moved and how quickly they will be moved. But I believe that it is obvious that large amounts will be moved, and, therefore, serious consideration should be given to the problem: What is the amount of such foreign deposits in U.S. banks at this time, what stable countries that exempt interest paid to foreigners can expect to benefit from the anticipated loss, and what tax can the United States hope to collect on deposits that are now withdrawn?

I have not touched upon the imposition of the estate tax. Of course, our corporate customers were not concerned about this matter, but two individuals were more anxious about this provision than the proposed income tax.

I honestly feel that this is a situation where we will be earning pennies and losing dollars, and our entire economy, not just the banking industry, will be better off if we refuse to tamper with a provision that has been so effective since 1921 and make this decision without delay.

I hope that I may hear from you again concerning this matter.

Yours very truly,

MAX A. MANDEL, *President.*

TREASURY DEPARTMENT,
Washington, D.C., June 10, 1966.

MR. MAX A. MANDEL,
President, The Laredo National Bank,
P.O. Box No. 59,
Laredo, Tex.

DEAR MR. MANDEL: Thank you for your letter of June 1 in which you discuss the provision appearing in the Foreign Investors Tax Act (H.R. 13103) subjecting to tax interest paid by U.S. banks after December 31, 1971, to nonresident aliens and foreign corporations not engaged in trade or business in the United States. We were most interested in your comments as to why you believe that foreigners holding deposits in U.S. banks will remove these deposits as a result of this provision in the legislation.

As I indicated to you previously, we are giving this matter our most careful consideration. We are pleased to have received the benefit of your views in this regard.

Sincerely yours,

STANLEY S. SURREY.

○