FOREIGN PORTFOLIO INVESTMENTS IN THE UNITED STATES

HEARING

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE AND RESOURCES

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

NINETY-FOURTH CONGRESS

SECOND SESSION

MARCH 1, 1976

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

67-994 WASHINGTON : 1976

COMMITTEE ON FINANCE

RUSSELL B. LONG, Louisiana, *Chairman*

HERMAN E. TALMADGE, Georgia
VANCE HARTKE, Indiana
ABRAHAM RIBICOFF, Connecticut
HARRY F. BYRD, Jr., Virginia
GAYLORD NELSON, Wisconsin
WALTER F. MONDALE, Minnesota
MIKE GRAVEL, Alaska
LLOYD BENTSEN, Texas
WILLIAM D. HATHAWAY, Maine
FLOYD K. HASKELL, Colorado
CARL T. CURTIS, Nebraska
PAUL J. FANNIN, Arizona
CLIFFORD P. HANSEN, Wyoming
ROBERT DOLE, Kansas
BOB PACKWOOD, Oregon
WILLIAM V. ROTH, Jr., Delaware
BILL BROCK, Tennessee

MICHAEL STERN, *Staff Director*
DONALD V. MOOREHEAD, *Chief Minority Counsel*

SUBCOMMITTEE ON INTERNATIONAL FINANCE AND RESOURCES

HARRY F. BYRD, Jr., Virginia, *Chairman*

MIKE GRAVEL, Alaska
LLOYD BENTSEN, Texas
WILLIAM V. ROTH, Jr., Delaware
BILL BROCK, Tennessee

ROBERT A. BEST, *Professional Staff*

CONTENTS

ADMINISTRATION WITNESSES

FOREIGN PORTFOLIO INVESTMENTS IN THE UNITED STATES

MONDAY, MARCH 1, 1976

U.S. SENATE,
SUBCOMMITTEE ON INTERNATIONAL
FINANCE AND RESOURCES
OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:34 a.m., in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr., of Virginia (chairman of the subcommittee) presiding.

Present: Senator Byrd, Jr., of Virginia.

Senator BYRD. The committee will come to order.

Today the Subcommittee on International Finance and Resources conducts a 1-day hearing to examine the Treasury Department proposal to eliminate the 30-percent withholding tax on dividends and interest paid to foreign persons on their U.S. investments.

At present this 30 percent is a mandatory rate unless it is modified by treaties entered into by the United States and other countries.

Also, there is an exemption for foreign countries on their interest in bank deposits in the United States but this exemption is due to expire December 31, 1976.

We are fortunate today to have six well-qualified witnesses to present their views. There will be Congressman Joseph L. Fisher from the 10th Congressional District of Virginia; the Honorable Charles M. Walker, Assistant Secretary of the Treasury for Tax Policy; Mr. Robert Roosa, former Under Secretary of the Treasury for Monetary Affairs; Prof. Peggy Musgrave of Northeastern University of Boston, Mass.; Prof. Hugh Ault of Boston College School of Law, and Mr. Tom Frost, Jr., chairman of the board, Frost National Bank of San Antonio, Tex.

[The Committee on Finance press release announcing these hearings follows:]

SENATOR HARRY F. BYRD, JR., ANNOUNCES SUBCOMMITTEE HEARINGS ON PORTFOLIO INVESTMENTS BY FOREIGNERS IN THE UNITED STATES

Senator Harry F. Byrd, Jr., (Ind.-Va.), Chairman of the Finance Committee's Subcommittee on International Finance and Resources, today announced that the panel will conduct hearings on March 1 to examine the Treasury Department's proposal to eliminate the present 30% withholding tax on dividend and interest income received by foreign persons on their portfolio investments in the United States.

The hearings will be held beginning at 9:30 A.M. on Monday, March 1, in Room 2221, Dirksen Senate Office Building.

It is the Subcommittee's intention to explore the role of foreign investments in the United States. The following witnesses have been scheduled to appear on March 1:

Honorable Joseph L. Fisher, Congressman from the 10th District of Virginia.

Honorable Charles M. Walker, Assistant Secretary of the Treasury for Tax Policy.

Mr. Robert Roosa, former Under Secretary of the Treasury for Monetary Affairs.

Professor Peggy Musgrave of Northeastern University of Boston, Massachusetts.

Mr. Tom Frost, Jr., President of Frost National Bank of San Antonio, Texas.

Professor Hugh Ault of Boston College, School of Law, Boston, Massachusetts.

Senator Byrd said that the Subcommittee would be pleased to receive written testimony from persons or organizations who wish to submit statements for the record. Statements submitted for inclusion in the record should be typewritten, not more than twenty-five double-spaced pages in length, and mailed with five copies by Friday, March 19, 1976, to Michael Stern, Staff Director, Senate Finance Committee, 2227 Dirksen Senate Office Building, Washington, D.C., 20510.

Senator BYRD. We will ask Secretary Walker to be our leadoff witness and to present the Treasury's proposal.

Under the Treasury's view, elimination of the 30-percent withholding tax on interest and dividends paid to foreigners would attract foreign investments. Critics of this proposal say that elimination may be followed by similar elimination in other countries, so there will be no net attraction by the United States. Who is right?

Secretary Walker, you may proceed as you wish.

STATEMENT OF HON. CHARLES M. WALKER, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY, ACCOMPANIED BY ROBERT PATRICK, INTERNATIONAL TAX COUNSEL, AND JOHN RAEDEL, ATTORNEY-ADVISER, OFFICE OF INTERNATIONAL TAX COUNSEL

Mr. WALKER. Thank you, Mr. Chairman.

I want to thank you for this opportunity to present to this subcommittee our views on the elimination of withholding taxes on dividends and interest paid to foreign investors.

At the outset, let me state that the Treasury Department and the administration believe that the existing withholding taxes on dividends and interest payments by U.S. persons to nonresident aliens and foreign corporations should be eliminated. We strongly support elimination of these taxes because of the defects inherent in the present tax withholding system and the benefits to be derived through its elimination.

Under present law, and subject to numerous exceptions, a 30-percent withholding tax is imposed on the gross amount of dividends and interest paid to foreign investors.

In our view, this present tax withholding system:

1. Handicaps U.S. companies seeking to raise funds in the international capital market.
2. Favors short-term debt investment at the expense of longer term investment; and
3. Has resulted in an unwarranted degree of complexity in our tax law which is now replete with exceptions for the tax-wise foreign investor and traps for the unwary.

The present tax withholding system handicaps U.S. companies seeking foreign capital in a number of ways.

First, the present system narrows and inhibits the market in which potential foreign investors operate. It places a great premium on complexity and discourages from investing at all those who are unable or unwilling to deal with these complexities, such as avoiding double taxation or finding the optimum route for tax treaty reductions. Certainly the development of our own national capital market would have been severely retarded if each State had imposed withholding taxes at varying rates on dividends and interest paid by local corporations to investors residing in other States.

Second, the present system inhibits an effective international secondary market in U.S. securities and securities which are not freely marketable throughout the world are not competitively attractive investments. Foreigners investing in U.S. securities today are generally those able to blunt the impact of U.S. withholding taxes through use of our network of bilateral income tax treaties which eliminate or substantially reduce these withholding taxes. However, these treaty exemptions and reductions are unsatisfactory in making U.S. securities attractive in international markets because they depend on the identity of the holder of the security. That is, they exempt only residents of treaty countries. This fact greatly restricts the negotiability of securities in international capital markets and greatly narrows the opportunities open to U.S. issuers abroad.

Third, U.S. borrowers seeking long-term funds are at a competitive disadvantage with borrowers of other major countries which do not impose withholding taxes on investments by nonresidents. Indeed, other countries recently have been taking legislative action to eliminate their withholding on interest obligations in order to give their borrowers greater access to international capital markets. For example, Australia in 1973, Japan in 1975, and Canada in 1975 enacted laws to exempt interest on long-term international bonds. They have joined other countries that already provide for exemption on international issues.

Finally, U.S. withholding taxes increase the capital costs of American companies. Foreign borrowing is either deterred or it is the American company, not the foreign investors, who bear the burden of U.S. withholding tax. For example, an American borrower who would otherwise borrow at 9 percent may be required to pay a nonresident as much as 13 percent to secure the same loan.

In addition, the present tax withholding system favors short-term debt investment rather than desirable long-term debt or equity investment. This bias arises as a result of the present exemptions from withholding for interest on bank deposits and other short-term obligations.

Finally, the present tax withholding system has resulted in a patchwork of statutory and treaty provisions, which, in sum, are not simple, are not neutral with respect to investment decisions, and do no raise significant revenue. Indeed, there have been so many ways around the U.S. withholding tax that the 30-percent tax on gross income either acts as a deterrent to investment or is noted more for its avoidance than its collection. These conclusions are perhaps best illustrated through a description of the exceptions available under the present tax withholding system.

Domestic legislation has singled out certain categories of income recipients to be free of withholding taxes.

Interest on U.S. bank deposits held by foreigners has traditionally been free from U.S. withholding tax and the Congress has extended such exemption on several occasions. The Tax Reform Act, passed by the House and now before the Finance Committee, makes this exemption permanent. The present exemption undoubtedly contributes to the present flow of foreign funds into bank deposits rather than longer term securities.

The Internal Revenue Code exempts from withholding tax, investments in stocks and debt obligations by foreign governments. There are major administrative problems in determining the scope of this exemption and its application to specific cases, particularly where the investment is made through an entity separate in form from the foreign government. A broad exemption would avoid the difficult administrative problem of making such determinations on a case-by-case basis through private rulings.

In some cases, withholding has been eliminated because it is not practical, as an administrative matter, to collect a tax. For example, there are very difficult problems in applying withholding where securities are issued at discount, and the economic benefit is realized subsequently through sale to third parties. Accordingly, short-term discount was removed from withholding in 1971. Similarly, capital gains taxes on U.S. investment assets held by foreigners were eliminated through amendments to the code in 1966.

Other exemptions have been established on conceptual grounds. Thus, U.S. companies having more than 80 percent of their gross income from foreign sources are not subject to withholding tax on dividends and interest paid to foreign investors. This rule, coupled with favorable Internal Revenue Service ruling practices, was the basis of a major financing device during the period when direct investment regulations required that U.S. companies who wanted to borrow for foreign investment had to do that borrowing abroad.

Statutory amendments tied to the interest equalization tax permitted the direct issuance by U.S. companies of debt obligations free from U.S. withholding and estate taxes. These possibilities for raising capital abroad are foreclosed today following expiration of the investment control programs and changes in ruling policy. This leaves U.S. companies largely unable to issue new securities in the international securities markets that trade free of withholding and estate taxes.

Major exceptions to the tax lie in our series of bilateral tax treaties. For many years, U.S. policy has been to seek treaties which eliminate withholding on interest payments. We have treaties with 12 countries which eliminate withholding and treaties with others which reduce the withholding rate. Similarly, we have a number of treaties which reduce dividend rates to 15 percent in the case of portfolio investment and 5 percent in the case of direct investment by a corporate investor. These rates follow the treaty model of the Organization for Economic Cooperation and Development, OECD, which has been widely adopted by member countries to reduce withholding taxes. These bilateral conventions in effect create a series of individual income tax codes under which income flows incur less tax when passed through a circuitous route of interlocking tax treaties. Inordinate time and effort is spent by tax planners in routing transactions and investments to obtain the most favorable arrangements. In some cases, this leads to the use of nominees and concealed ownership.

The treaty network already serves to reduce or eliminate withholding in the case of the bulk of investments which are actually in place today. In 1973 more than 90 percent of nonbank interest and dividend income flowed to residents of treaty countries.

The important lesson of treaty experience, however, is that elimination of withholding taxes on dividends and interest paid to foreign investors is not only a practical result but has long been recognized as sound tax policy.

The question of dividend and interest income was considered more than 50 years ago by a commission of tax experts established by the League of Nations. They concluded, back in 1923, that the right to tax investment income properly belongs to the State of the taxpayer's residence. This principle has been reaffirmed in the commentaries to the OECD Model Convention, while recognizing that some States may wish to maintain some minimal withholding tax solely on revenue grounds.

With respect to those investments in the United States that have not been deterred by withholding taxes, the net effect of the various statutory and treaty exemptions has been to substantially lower the average rate of withholding tax. For 1973, the total withholding taxes collected on dividends and interest other than bank interest, were less than 10 percent of the gross payments despite a basic statutory rate of 30 percent. Further, the amount of tax actually collected is very small. In 1973, only $210 million of withholding tax was collected of which less than $20 million is clearly identifiable as withholding on interest.

Thus, the revenue aspects of withholding are not major. In sum, we are persuaded that our present tax withholding system is counterproductive in hampering our economy, denying access to foreign capital markets, favoring short-term foreign debt investment, and needlessly complicating our tax law in order to raise so little revenue. Rather, we recommend the elimination of withholding taxes on dividends and interest paid to foreign investors.

In our view, elimination of withholding tax on investment income is desirable because:

1. Removal of the tax will make investing more attractive and less difficult for investors. It will make it easier for U.S. companies to seek funds in international capital markets and will enhance market efficiency for investment in the United States. At a time when projections show a need for increased capital sources, we should be concerned over the efficiency of our tax system when applied to foreigners otherwise willing to place their funds in the United States. By elimination of the withholding we reduce the tax burden on capital formation.

2. It should improve the relative attractiveness of long-term securities and reduce the present bias, favoring short-term obligations and bank deposits.

3. It may help retore the U.S. financial community to the center of international capital markets.

67-904—76——2

4. It is consistent with principles of tax equity and other rules relative to source of income.

5. It will eliminate what has become a complex patchwork of legislative and treaty provisions and simplify one area of tax law.

The basic point is that the many benefits of eliminating withholding outweigh the revenue loss and thus, on balance, we believe it is the best approach to take.

We urge elimination of withholding not only with respect to interest income, where a 30-percent tax on gross payments of interest is a clear impediment, but also for dividend payments. There is no reason to perpetuate favorable tax treatment for debt investment over equity investment. Many foreign investors are interested not only in capital appreciation, which we do not tax in the case of a foreign investor, but in yield. The 30-percent tax on portfolio dividends is clearly a deterrent to those relying on the investment yield. This deprives many of our businesses of access to a form of capital they urgently require.

Before concluding, however, let me treat briefly with some of the reasons offered for retaining the present withholding system.

It has been suggested that elimination of tax withholding is costly and would merely give foreign investors a free ride at the expense of the U.S. Treasury.

As noted earlier, because of the large number of exemptions and rate reductions under the present system, these taxes deter additional investment and raise very little of our total revenue. Indeed, for 1976 it is estimated that withholding tax collections will account for less than one-tenth of 1 percent of total revenue. Moreover, it should be noted that to the extent the elimination of withholding results in increased foreign investment in the United States, additional U.S. tax revenue will be generated from the increased economic activity created by such investment. Finally, to the extent foreign investors qualify for exemption under the present system or the present withholding taxes are borne by the U.S. borrower through an increased interest cost, foreign investors already get this so-called free ride.

There is some concern over the effect of our unilateral removal of withholding taxes on our bargaining position in tax treaty negotiations. The development of a system of bilateral treaties for avoidance of double taxation led in the past to the adoption of reciprocal reductions in withholding tax rates. However, the new realities are relatively clear. The developing countries with limited amounts of investment in the United States generally do not seek to have the United States reduce its withholding tax and the United States has generally not sought in its discussions with developing countries to persuade them to forego revenues by reducing their withholding tax rates.

Moreover, we now have tax conventions with the majority of developed countries, virtually all of which already provide for reduced withholding rates. Finally, in the cases where we renegotiate these treaties, developed countries generally do not have the reduction of our withholding taxes as a major treaty objective. Thus, today U.S. withholding rates are of limited significance in treaty bargaining.

Some European country treasury officials have expressed concern in recent years over tax avoidance by their residents investing in the Eurobond market in which the securities are issued in a manner which makes them free of withholding at the source. They have suggested the desirability of imposing uniform withholding taxes on securities issues, with some form of verification and refund system. On the other hand, some European capital importing countries, which do not have withholding tax on interest today, have opposed this suggestion and have pointed out that the imposition of a withholding tax at the source at a 20- or 30- percent rate may make tax avoidance somewhat more expensive, but will not deter avoidance for persons in higher marginal income brackets.

We are mindful of the problems raised by tax avoidance, but do not believe that it is necessary to structure our internal tax system to make up for the inadequacies of individual countries with respect to the taxation of their own citizens. Thus, we believe it desirable to avoid cumbersome withholding and refund systems, but we do support the concept of expanding information reporting and the exchange of information to permit countries to have access to data they may require for tax enforcement. The Treasury Department has suggested that legislation eliminating withholding should also permit the imposition of a withholding tax in the case of a country that refused to cooperate in identifying recipients of dividend and interest payments where there is believed to be a substantial problem of tax evasion. This discriminatory stick should be more effective than our existing rules in dealing with foreign tax havens.

In conclusion let me again emphasize that it is time we reform the tax withholding system. We believe that the investments the present tax withholding system discourages and the complexity it creates are much more significant than the amounts of revenue it produces. Revenues gained from increased investment and economic activities in the United States will offset revenues lost. It is in our national interest, on both economic and tax policy grounds, to eliminate withholding on dividend and interest income. We should do so, and do so promptly.

Senator BYRD. Thank you, Mr. Secretary.

What do you estimate would be the revenue lost for 1976, 1977, 1978, 1979, and 1980?

Mr. WALKER. These figures are shown on annex B to the statement, Mr. Chairman. We have broken these revenue estimates down according to interest and dividends on portfolio investments and on direct investments.

Assuming the withdrawal of the withholding on both portfolio and direct investments on interest and dividends for 1976, it would be $205 million total.

Senator BYRD. Is this fiscal 1976 or calendar 1976?

Mr. WALKER. It is calendar year, Mr. Chairman.

Senator BYRD. I have some figures showing that by 1978 the revenue lost would be $340 million; in 1979, $365 million; and in 1980, it would be $390 million; all figures substantially lower than these.

Mr. WALKER. Could those figures, Mr. Chairman, also include bank interest?

Senator BYRD. Those figures would include the withholding tax on dividends and bank interests, yes.

Mr. Walker. I think the ways and means bill as presented, would make that exemption on bank interest permanent.

Senator BYRD. So, the figures you are supplying, then, apply only to what?

Mr. WALKER. To interest other than bank interest plus dividends.

Senator BYRD. Why can't you solve this problem by treaties?

That is the way you say somewhere in your statement: "In 1973 more than 90 percent of nonbank interest and dividends income flowed to residents of treaty countries."

Mr. WALKER. Mr. Chairman, while treaties do deal with the subject of withholding on a mutually arranged basis, the current schedule for treaty negotiation doesn't have a large number of treaties scheduled for renegotiation. Moreover, as I pointed out in my testimony, the effectiveness of arrangements in treaties does require an identification of the holder as a resident of the treaty country. This does impact and severely impair the free negotiability of the securities involved because they can't be traded back and forth except within the market, shall we say, of other members of the same treaty country.

Senator BYRD. What was the rationale behind putting this provision into the law in the first place?

Mr. WALKER. The withholding tax?

Senator BYRD. Yes.

Mr. WALKER. I think it was just a revenue measure. It has been in place for a long, long time and the treaty negotiations have acknowledged the fact that it isn't the soundest thing to have.

Thus we have negotiated in some cases, a removal and in some cases a reduction of the withholding tax.

Meanwhile, the multinational character of the investment in commercial activities has created an increasing need for the worldwide free flow of capital.

Senator BYRD. What countries would be the most affected beneficially by changing this law?

Mr. WALKER. I think the United States would be the most. I didn't mean to be facetious, Mr. Chairman. I really don't know that I would focus on any particular country being the beneficiary of the provision. I think it is within our own self-interest that we do it.

Also, any security holder in a treaty country would gain the future advantage of being able to have a wider market for secondary marketing of his holdings.

Senator BYRD. You say that 90 percent of nonbank interest and dividend income flowed to residents of treaty countries.

If this provision is eliminated, the residents of which countries would be the most concerned beneficially with this?

Mr. WALKER. I presume the countries with which we have the highest withholding rates. Even so, as I mentioned a moment ago, all of the people in these treaty countries would gain the further advantage of a wider market for their securities.

They would be able to market them with others who were not fellow members of their country.

I don't know that I can focus precisely on a particular country, Mr. Chairman, if that was the thrust of your question.

Senator BYRD. Yes, that is the thrust of my question.

Mr. WALKER. Let me take a moment and see if I can get a sharper focus on it.

I just don't have a sharper answer for you, Mr. Chairman. I will strive to obtain one.

Senator BYRD. If you can make a sharper answer, fine. If you can't, let it go.

You say we strongly support elimination because of defects inherent. What defects are you speaking of?

Mr. WALKER. One principal defect is that U.S. companies seeking foreign financing and foreign investors seeking to invest in the United States are forced to use a complex and discriminatory set of treaties and statutory rules to achieve a reduced withholding tax when that result could be more directly achieved by just not having withholding there in the first place.

Senator BYRD. Doesn't this give you a tool that is helpful to the Treasury Department?

Mr. WALKER. I am sorry.

Senator BYRD. Doesn't the present provision give you a tool that would be helpful to the Treasury Department?

Mr. WALKER. There are tools there, Mr. Chairman, but they are tools that are burdensome to utilize. For example, there must be verification where there are payments to what would appear to be members of treaty countries with a low withholding rate. The fact that the payment is made genuinely to a resident of that country must be verified.

This presents problems of enforcement and administration.

[Annex A and B to Mr. Walker's statement follows:]

ANNEX A.—INTERNATIONAL PRACTICE ON WITHHOLDING TAXES ON INTEREST

The following is a recent survey of foreign countries exempting withholding on interest on obligations (other than bank accounts) paid by domestic issuers to foreigners:

Austria.—Interest paid to nonresident lenders is exempt.

Australia.—Interest payments by a resident to a nonresident are exempt from payment of the 10% withholding tax if the interest liability is incurred in carrying on a business in a country outside Australia through a permanent establishment in that other country. Furthermore, the income tax law amended in 1971 to exempt any interest payments: (i) made in a foreign currency on public issues or widely offered private placements of bearer bonds, if the bonds were issued in a foreign currency outside Australia by Australian companies for use in their Australian businesses; or (ii) made on bearer bonds in a foreign currency, if the bonds were issued in a foreign currency outside Australia by Australian companies for use in a business which is wholly or substantially Australian owned and controlled.

Belgium.—With respect to loan agreements entered into between March 1, 1968 and December 31, 1971, Belgium granted an exemption from withholding for interest paid by Belgian industrial, commercial or agricultural enterprises to nonresidents who had no permanent establishment in Belgium in cases in which the loans served the purpose of financing operations of general economic interest and contributed directly to the establishment, expansion, conversion or modernization of the borrower. (Artc. 89, § 2, 6°, C of Royal Decree of March 4, 1965, Royal Decree of January 5, 1971, 1971 Moniteur Belge 763 (January 21, 1971)). This exemption was applicable to private and public borrowings and no requirements as to maturities were imposed. The only exemptions from withholding presently available in Belgium cover interest paid to nonresidents on (1) loans to and deposits in banks established in Belgium made by foreign banks, and (2) registered obligations of, and deposits in, Belgium banks and certain other financial institutions.

Canada.—The Canadian Income Tax Act was amended in 1975 to exempt from Canadian tax interest which Canadian companies pay to unrelated nonresidents on obligations issued after June 23, 1975 if, under the terms of such obligations, the company may not be obliged to pay more than 25 percent of the principal amount thereof within five years of the date of issue.

Denmark.—Interest paid to nonresident lenders is exempt.

France.—Under Article 131 ter 1 of the Code Generale des Impots, the Minister of Economy and Finance is authorized to exempt from French withholding tax payments of principal and interest made outside France on special issues of bonds floated abroad by French companies or enterprises. Under this provision, the Minister has authorized exemptions for private placements with a small number of lenders as well as for public issues. No limitations on the maximum period to maturity have been imposed. By Degree of January 7, 1966, codified as Article 41 Duodecies C of Annexe III of the Code Generale des Impots of France, exemption from withholding is also given to interest on deposits of foreign currency with French banks and to income on certain short-term transactions between French banks on the one hand and foreign banks, international organizations and foreign financial institutions on the other. Moreover, in the 1975 Finance Law, passed on December 30, 1975, France has further expended its tax exemption for interest payments to nonresidents.

Finland.—Under the "Act on Taxation of Income and Property", Article 7, Section 2, Finland exempts from income tax all bond interest paid to foreign lenders. This provision was first enacted in 1966 as an interim measure to be effective for one year. This law has been renewed from year-to-year, most recently on December 29, 1972, for the year 1973. In 1973, the provision was amended ~~so~~ as to exempt from Finnish income tax all interest paid to foreign lenders on foreign loans, including foreign private placements.

Italy.—Italian law provides an exemption from withholding for interest paid to nonresidents on certain loans contracted and bonds issued outside Italy. This exemption, which has been available since April 28, 1970, was to expire on January 7, 1974 unless extended.

Japan.—Under special legislation in Japan, interest payable on foreign currency debt securities issued by Japanese companies during the period from April 1, 1968 to March 31, 1972 and having maturities of not less than five years are exempt from withholding if paid to nonresidents of foreign corporations not having permanent establishments in Japan to which the interest is attributable. It is understood that similar relief was extended in 1974.

Netherlands.—Interest paid by a Dutch financing company is ordinarily exempt from withholding.

Norway.—Interest paid to nonresident lenders is exempt.

Sweden.—Interest paid to nonresident lenders is exempt.

United Kingdom.—If a borrowing by a resident borrower from a foreign lender is governed by foreign law, the interest is exempt from withholding at the source. In order for the interest to be deductible by the borrower, the borrowing must comply with additional restrictions on the place where, and the currency in which interest is paid and on the purpose of the borrowing. (Income and Corporation Taxes Act 1970, §§ 248(4)(b), 249(1)).

ANNEX B.—PROJECTED REVENUE EFFECTS OF THE ELIMINATION OF WITHHOLDING TAXES ON DIVIDENDS AND INTEREST PAID TO FOREIGN INVESTORS

[In millions of dollars]

	1976	1977	1978	1979	1980
Elimination of tax on:					
1. Interest from portfolio investment	15	20	25	30	35
2. Dividends from portfolio investment	150	160	170	180	190
3. Interest from direct investment	2	2	2	3	3
4. Dividends from direct investment	38	42	46	50	54
Totals:					
Portfolio interest and dividends	165	180	195	210	225
Direct interest and dividends	40	44	48	53	57
All interest and dividends	205	224	243	263	282

Senator BYRD. Suppose we hear now from Mr. Robert Roosa, former Under Secretary of the Treasury.

Mr. Walker, if you care to, you can stay a while.

Mr. WALKER. Thank you.

STATEMENT OF ROBERT ROOSA, FORMER UNDER SECRETARY OF THE TREASURY FOR MONETARY AFFAIRS

Senator BYRD. Good morning, Mr. Secretary. You may proceed as you wish.

Mr. ROOSA. Thank you, Mr. Chairman, very much.

Senator BYRD. We are glad to have you here.

Mr. ROOSA. I certainly am glad to have a chance to again appear before the subcommittee of the Senate Committee on Finance.

As you have indicated, my name is Robert Roosa and I am here as chairman of the New York Stock Exchange Advisory Committee on International Capital Markets and also as a partner in Brown Bros., Harriman & Co., a private banking firm located in New York City.

With your permission, Mr. Chairman, I would like to submit a somewhat fuller statement for the record and merely summarize it quickly and get on to the discussion.

Senator BYRD. I think that is a very good way to handle it.

Your complete statement will be published in full in the record.

Mr. ROOSA. I generally agree with the position advanced by Secretary Walker, and that probably gives me even a more simple basis for summarizing the position presented at greater length in my statement.

I think it is important to emphasize the starting proposition, Mr. Chairman, that the pendulum has turned with respect to the flow of foreign investment into and out of the United States, and it is significant for this economy.

At least in my own view we have reached a stage where, partly because of the environment created in the aftermath of the dramatic oil price change and the shifting in balance-of-payments positions that that has produced, the United States no longer can be primarily or solely a capital exporter.

There is a clearer basis for us to share in whatever part of the investable proceeds of the OPEC countries can come here, as allocations are made among the developed countries.

We all know that much, they have to go to the less developed countries where there are other crying needs, but a substantial part will in any event go to the developed countries.

This country, in my view, is going to have on balance an overall shortage in the availability of capital, particularly long-term capital, for many years to come.

We ought to be making a stronger claim to get that capital.

I think, therefore, that one of the most powerful ways to help attract foreign investment is to eliminate the withholding tax on interest and dividend income on portfolio investment.

I would even emphasize, perhaps more than the Secretary did, the longer run net gain to the economy from repealing the tax in terms of increased jobs, higher incomes and a larger tax base here.

I think that the combined effect of these over the long run is to much more than offset any short-run loss to the Treasury in revenue.

In accord with that, I would think that, as I will indicate in a second, it will much more than offset the indicated revenue loss which I suspect, for the sake of avoiding too much quibbling of detail, may even be overstated in the figures that the Secretary has presented.

I want to mention one other issue to which you have referred, Mr. Chairman, and in passing the Secretary did also. That is, that we do have coming up at the end of the year under the present law the lapsing of the exemption even with respect to nonofficial foreign bank deposits in this country.

While I would agree with the Secretary that we want to emphasize longer term investment, we don't want to discourage to the point of forcing or encouraging withdrawal of the deposits that have already been built up here.

I think the very same ground on which I am trying to urge the extension of the withholding exemption to bond interest and stock dividends does support retention of the exemption of nonofficial foreign bank deposits along the lines that are proposed and still are included in the present House bill.

I am not sure that it is clear why this is important now, but so many time deposits, written for foreigners in particular, have a maturity of 1 year.

With the present status of law, foreign banks, anxious to attract back from us deposit balances that are held here, are already fishing in these troubled waters, indicating to those who have balances on deposit here, in 1-year time deposits, as they mature that it isn't safe to provide for renewal of them or at least you are opening yourself to the potential liability under present existing U.S. law that they will be subject to withholding at least by the end of this calendar year.

It does seem, therefore, that even in this area, it is important to take speedy action or we are going to see a gradual erosion of the billions and billions of deposit money that is here, in part deposit money that has taken that form rather than long-term investment, because it is exempt from the withholding tax.

I would rather see the shift into long-term investment here than to see it driven out of the country altogether. I don't think that is too difficult a preference to express.

I think also that something ought to be said about recent investments.

The Secretary mentioned that 90 percent of the potential tax base here flows to countries which are tax treaty countries. At a certain point when those data were put together that was true.

I am quite prepared to walk into the hornets' nest of indicating that that is not true now because a very substantial part of what could be invested here and could be earning interest here would come from the OPEC countries.

I think it should come, but it is being deterred.

You may have noticed a Treasury release a few days ago to the effect that, while there was a reduction in OPEC investment here in 1975 compared to 1974, there was an increase in equity investment. That does seem puzzling, if I am here asking to remove the withholding tax as a way of encouraging that equity investment.

Senator BYRD. Could I interrupt at this point?

Mr. ROOSA. Yes.

Senator BYRD. Is it not correct that under section 892 of the Internal Revenue Code those countries already are exempt?

Mr. ROOSA. No, sir. That is what I want to explain. As a government investment for a governmentally related purpose, they are exempt, but any corporation that is a governmental entity must seek and receive a specific exemption from the Internal Revenue Service in order to gain that exemption.

Senator BYRD. Why can't they do that by treaty just as easily?

Mr. ROOSA. As far as the treaty provision is concerned, as you know, most of the treaty negotiation—and by the way, I am perfectly prepared to say that we ought to have both tax treaties and treaties of commerce and navigation with all of the countries in the Middle East, and I recommended that to Secretary Kissinger 3 or 4 years ago.

I am not disagreeing with you, but I am here proposing that in this area the straightforward, simple, across-the-board way, much less cumbersome and complex, is to eliminate the withholding tax because, in general, what has been done under the tax treaty has been a reduction but not elimination.

Of course, elimination in 12 countries for interest on bonds has occurred, but there has rarely been a case of eliminating the withholding on dividends.

In the case of Israel, for example, the present provision is only that we reduce the withholding on dividends from 30 to 25 percent and on interest from 30 to 17.5 percent.

There we do have a tax treaty, but we have neither tax treaties nor treaties of commerce and friendship with any of the other Middle Eastern countries. I think it is important that we have them.

It does lead, even then, to a discriminatory patchwork which certainly at least has the effect the Secretary has indicated of making it very difficult to have broad secondary markets for any outstanding securities because whenever a security passes, there is a change in the tax status, depending on what the peculiar provision of the tax law is in the residence of the person buying the security from the seller.

It makes it even more difficult in the case of the marketmaker who stands in the middle as a dealer or a broker.

I would revert again, Mr. Chairman, to a little explanation, at least my own explanation of why we did have this peculiar increase in OPEC investment in equities in 1975, an increase of $1 billion, something that I am here urging we should have.

To a large extent, that came about under the provision of Internal Revenue Service rulings which had been awaited for some time, which came through in 1975, which are themselves limited in scope.

It did, as a first impact, provide for an inflow through that means of a substantial amount of money that did belong to government entities in Middle Eastern countries.

Because the Internal Revenue Service must continue under the law to observe and to verify that there is a governmentally related purpose, that is why, of course, they have chosen portfolio investment, to try to play down any implication that they are reaching beyond that in order to have an equity controlling interest in any manufacturing operating distributing company.

It is my understanding from the conversation and negotiations I have had with most of those Middle Eastern countries that they are anxious to avoid—there are exceptions—circumstances in which their governments would have anything that would look like a controlling interest, even more than a 5-percent-equity interest, in firms here because they want earning assets that will preserve the value of the capital they have now achieved and obtained, rather than the invidious problems of exercising control.

Therefore, within that kind of framework and understanding, the IRS has issued rulings. I must say the rulings are traditionally ambiguous. I am not purporting to be a lawyer and say that I fully understand them, but I do know that government entities in all of those OPEC countries, who are going to have resources to invest net in this calendar year, are uncertain as to what their status is going to be under the provisions of that set of rulings beyond this calendar year.

There is a question of where they will invest and how and whether it will still be considered consistent with the governmental purpose or whether it will take it on a broader implication.

For that reason, I think we have to look through this provision.

You may remember that when I was up here as Under Secretary I did propose, which, of course, was an administration proposal, what eventually did become law, a flat and permanent exemption for the interest received by foreign central banks.

That stands as statute.

Therefore, wherever the Internal Revenue Service will issue a ruling indicating that the central bank is operating in its capacity as a central bank and not as a mutual fund, that central bank investment will continue to be exempt, but even there doubt will remain.

There may be other ways of handling it, but the clearcut way which gets many other benefits as well is to cut across the board and eliminate the withholding tax altogether.

Senator BYRD. Aren't you saying, then, that the Treasury has wide latitude in this regard?

Mr. ROOSA. The Internal Revenue Service does, yes, but only to the extent that they are prepared to stretch the boundaries of interpretation under the general provision, which Congress has established, that the investment itself must be clearly related to a governmental purpose.

Senator BYRD. Aren't you also saying, in giving an answer to my previous question to Secretary Walker, as to which countries would be the chief beneficiary, as I understand from you, it would be the Middle East countries.

Mr. ROOSA. Yes, I am. Of course, there will be considerable advantage all the way around because I am sure there isn't a single country where, with respect to dividends even under the tax treaties, anyone gets down to less than 15-percent withholding.

If there were to be a change—and each watches the other, of course—if we wanted to get down to zero through the tax treaties, we would have to initiate negotiations for the revision of some 25 existing tax treaties, all of which provide differently, between 15 and even 30 percent of withholding on dividends.

There will be benefits under what I am proposing to all of these countries and a little bit more to those which have the highest withholding rates.

Yet the entire list will have considerable benefit.

I have already mentioned the position of Israel, which has very little benefit under the tax treaty. Australia, Austria, Belgium, and Canada are down to 15 percent, and so on. Therefore, the benefit of cutting the withholding on dividends will extend to all.

Then, I would reinforce what the Secretary said, that by making the treatment uniform you greatly increase the capacity to develop secondary markets in these securities.

My views are those of a person who has spent his life in the investment market and mainly in trading secondary securities; I have never been engaged in underwriting. Our firm is not permitted to do underwriting now. All I do is trade in the secondary markets.

I can certainly assure you that when tax treatment is uniform, the breadth of those markets becomes immeasurably improved, just as when other kinds of provisions are made uniform.

We deliberately imposed a hazard at the time that I was up here proposing the interest equalization tax, which had to be introduced for a brief period for a clear purpose.

The tables have now turned enough so that what we are trying to do at this stage, instead of causing or at least putting restraints on funds that would flow out of the United States by in effect raising of the interest costs to others, we are this time trying to take away an impediment which applies in discriminatory ways across the board to investors, depending on whether they buy stocks or bonds and depending on where they live.

Senator BYRD. What has been the extent of equity investment by the Middle East countries in the last couple of years?

Mr. ROOSA. What is the extent?

Senator BYRD. Yes.

Mr. ROOSA. The Treasury estimate—and they would come closer to knowing than anyone else—is I believe $350 million from all OPEC countries. That is not just Middle East. I didn't see a breakdown, but this could include the whole southern tier of the Mediterranean and also, if there were any funds to invest in Nigeria, and Indonesia and Venezuela—certainly Venezuela did have some—and Ecuador.

There were about $350 or $360 million in 1974 and about $1.4 billion in 1975. Even in 1975 that represented only 3 percent of the investable funds that the OPEC countries had. This is not their total funds. Their total receipts were in the rough magnitude of $110 billion.

They spent a lot of it on the other things but they had available then for investment, as is estimated by the Treasury, in calendar 1975 about $42 billion. Of that, in the equity side of the market, OPEC countries invested about 3-percent out of the $42 billion in the United States.

Senator BYRD. Where is all the rest going, then?

Where is the 97 percent going?

Mr. ROOSA. Part of it, of course, is difficult to track, but roughly—again, I am recalling Treasury figures—there was a substantial, a somewhat larger part that went into the Common Market countries.

If we round this in billions, and I perhaps should correct this for the record because I am calling on a memory now that sometimes fails, it was compared to $1.4 billion coming here, the Common Market, I believe, got around $3 billion, and then the OPEC countries sent about $6 billion, into other Arab countries in particular.

So, it was Arabs to Arabs for the most part there.

Then, there was another roughly $4 billion that went to international organizations, IMF, IBRD, et cetera, that still doesn't get us up to not even quite half of the total.

Then there was a substantial amount which they invested in the Eurodollar market and therefore was undifferentiated as to which countries received it.

If I remember rightly, that estimate runs higher, something in the order of $7 billion. Apart from the Treasury estimate, other people have estimated that as high as $11 billion.

Then when you get all done, there was also a certain amount of investment among those countries themselves where they were making new investment in long-term projects that don't count as immediate spending.

There are still about $7 or $8 billion unaccounted for, that Treasury just can't track in the present state of its information. This is, of course, something where, along the lines of the Secretary's comment, there is clearly a need for more surveillance and information.

It is to be hoped that this is one outcome that will emerge after the country has ratified the agreements that were made on the monetary side in Jamaica, where in the second week of January this year they finally did reach agreement on a number of issues involved in international payments procedures, and so on.

Senator BYRD. Would Secretary Walker take the witness table and comment on the extent of Middle East investment?

It seems to me that Treasury may well be substantially underestimating the amount invested in equities in this country by Middle East countries.

Mr. WALKER. Mr. Chairman, I was just reviewing, as this dialog was taking place, a statement which Assistant Secretary Gerald Parsky made before the Subcommittee on Foreign Commerce and Tourism of the Senate Committee on Commerce just a few days ago, February 23.

Just thumbing through it, I see he refers in one portion of that testimony to the OPEC investments. I don't know that I have figures which dovetail precisely with those that you were reading, Mr. Roosa, but I would be glad to supply this for the record if you would care to have it, Mr. Chairman.

It does contain a table showing the investment pattern of the OPEC surpluses during 1974 and part of 1975. However, Mr. Chairman, I couldn't give a fast response to what has been said, but the data is available and we would be glad to develop it in more detail for the record, if you would care to have it, because it certainly is relevant to the current inquiry.

Senator BYRD. I think it is.

If you can supply additional information, that will be helpful.

[The following material was subsequently supplied by the Department of the Treasury:]

THE DEPARTMENT OF THE TREASURY,
Washington, D.C., March 5, 1976.

Hon. HARRY F. BYRD, JR.,
Russell Senate Office Building,
Washington, D.C.

DEAR SENATOR BYRD: Enclosed, as you requested during my testimony before your Subcommittee on International Finance and Resources, is a copy of the most recent Treasury estimates of OPEC country investment in the United States for 1974 and 1975. With reference to these estimates, it should be noted that less than 20 percent of the OPEC surplus for 1974 and 1975 was invested in the United States, mostly in short-term obligations, and that the amount invested as a percentage of the total decreased in 1975.

Again, let me thank you for the opportunity to present the Treasury and Administration views on the elimination of tax withholding, and if I can be of further assistance please do not hesitate to call upon me.

Sincerely yours,

CHARLES M. WALKER,
Assistant Secretary.

Enclosure.

CURRENT TREASURY STAFF ESTIMATES OF OPEC SURPLUSES AND INVESTMENT PATTERN

(Dollar amounts in billions)

	1974		Preliminary 1975	
	Amount	Percent of total	Amount	Percent of total
In the United States:				
Short-term portfolio investment	$9.3		$0.1	
Long-term portfolio investment	1.5		5.4	
Other	.45		.75	
Total in U.S.	11.25	19	6.25	15
In Euro-banking market (including United Kingdom banks, other European banks, and offshore banks)	22.5	37.5	7.0	17.0
Other to United Kingdom	7.5	12.5	.25	.5
Other to developed countries	5.5	9.0	7.0	17.0
IFI financing and IMF oil facility	3.5	6.0	4.0	9.5
Other to LDC's (including grants)	4.0	6.5	6.5	15.0
All other	5.75	9.5	11.0	26.0
Total	60.0	100.0	42.0	100.0

Senator BYRD. In your statement, Mr. Walker, you say:

We are mindful of the problems raised by tax avoidance but we do not believe it is necessary to structure our internal tax system to make up for the inadequacies of individual countries.

In the next paragraph you say:

The Treasury Department has suggested that legislation eliminating withholding should also permit the imposition of a withholding tax in the case of a country that refused to cooperate in identifying recipients of dividend and interest payments where there is believed to be a substantial problem of tax evasion.

Aren't those two paragraphs contradicting each other?

Mr. WALKER. I don't think they are, Mr. Chairman. The first portion relates to the taxation by foreign countries of their citizens and residents. These countries seek to have us impose a withholding tax, perhaps with a refund system, which will permit them to trace the income of their citizens and residents. We do not see the need for the United States to compensate for another country's inadequacy in enforcing its own tax system.

The latter portion that you referred to, Mr. Chairman, has to do with our undertaking, despite a removal of the withholding provisions, to nevertheless impose a withholding tax if we were to find that there was abusive use made of tax havens, for example, by U.S. citizens and residents.

Senator BYRD. You are not speaking of tax havens in this country but tax havens in foreign countries?

Mr. WALKER. Yes, tax havens in foreign countries.

I don't think they are inconsistent positions, Mr. Chairman.

Mr. ROOSA. For the record, Mr. Chairman, that is the only provision of the Secretary's statement with which I would not agree.

Senator BYRD. It seems to me that it is contradictory. You say up here, "We do not believe it is necessary to structure our internal tax system to make up for the inadequacies of individual countries".

Mr. WALKER. What we seek to avoid is becoming a part of an arrangement in which there would be a withholding tax and a refund of the tax.

Senator BYRD. Let me ask the two of you just one additional question, and then I will call on Professor Musgrave.

Is it likely that the elimination of withholding tax would only attract foreign residents to invest in existing ownership, that is, invest in currently operated companies rather than in new business.

If so, how would that tend to create additional job opportunities?

Mr. ROOSA. I don't want to seem proselytizing, but I have a personal proposal which I have advanced as of about 1¼ years ago, which would aim to center the OPEC investment entirely in new projects where again their controlling interest would be kept minor.

These take a while to evolve, but I do feel that this is on the way.

It will require additional effort and arrangements, but I think it can be done.

It is also true that much of what flows in, initially at any rate, would be just broadly speaking into the marketable securities that exist.

What these funds do, both in the secondary market and the original issue market, is provide a part of the finance for the heavy volume of additional corporate borrowing, which is coming along.

Also, by providing a substantial continual purchasing source in the capital markets, it will create an environment in which U.S. corporations can issue additional amounts.

So, whether the funds flow always directly into a new issue, the indirect effect is to support a market in which many new issues are occurring and to make it possible for more of those to occur.

We have had a little slump, as you know, this year in the rate at which new corporate borrowing has occurred.

But, because it is a fair-weather market and the stock market has risen, we are now getting a cluster of new issues of corporate stock. I hope there will be many more.

It is in that kind of an environment where OPEC investment, even if it is to a considerable extent going into old issues, flows through the market and eventually supports and provides the funds which go into the new equity investment.

I feel that in this case, Mr. Chairman, the money is really fundable and the net addition means supporting added investment whether you can trace it initially or not.

Senator BYRD. You point out, Mr. Roosa, that every Common Market country except Germany has more accommodative tax treatment for foreign investors.

Mr. ROOSA. Yes.

Senator BYRD. Doesn't the United States still have a more attractive investment market?

For example, doesn't the rate of inflation in the United Kingdom, despite no withholding tax on dividends and interest, make it a less desirable place for foreign investment?

Mr. ROOSA. Absolutely. Therefore, it takes a pretty big deterrent to divert investment from here to somewhere else.

For many investors the withholding tax is that margin of difference.

Senator BYRD. Let me ask you to disgress a moment from the precise question that is before the committee today. How do you see interest rates in the United States 6 to 12 months from now?

Mr. ROOSA. I think it will partly hinge on this, not that this can be a major, wholly determining element. It is going to be more important what the Federal Reserve is doing and what the economy is doing.

Without describing all those assumptions, the net of it in my view is that both long- and short-term interest rates will be modestly higher 6 to 12 months from now. I think it is likely to just take the end of the year as a benchmark, that our rates on the whole cluster in the short term market, which has lately centered around the Federal fund rate of 4¾ to 5 percent, and with commercial paper and bankers' acceptances and bankers' CD's all down very close to 5 percent, a very tightly clustered short market, it will begin to fan out and I think probably we will see Fed fund rates by the end of the year, something over 5½ percent but a fanning upward where many of the other parts of that market will be in the neighborhood of 6 percent.

This is putting my neck way out, but I am just trying to give an order of magnitude change.

I would think that along with that, in much of the long-term market, again depending on quality and maturity, there will be rates that will be a quarter to a half of 1 percent above today's level.

By total's level, I mean last Thursday's level, because you get some bouncing around so that it is hard to use a benchmark. That means, just to be precise as to rate, that a Double A utility, if we know what that is, which is a pretty broad range of companies, is going to be something above 9 percent and probably in the order of 9¼ at the end of the year.

Senator BYRD. What you say sort of coincides with my own view, that we will have a relative stability in 1976.

Mr. ROOSA. Yes.

Senator BYRD. I am inclined to think that we are going to face some different problems come the middle or the latter part of 1977 and 1978.

Mr. ROOSA. I think so, too.

Senator BYRD. On the inflationary side.

Mr. ROOSA. Yes, I carefully didn't extend any comments into this problem.

Senator BYRD. I notice you cut it off on December 31, 1976.

Mr. ROOSA. Yes.

[The prepared statement of Mr. Roosa follows:]

PREPARED STATEMENT OF ROBERT V. ROOSA, CHAIRMAN OF THE ADVISORY COMMITTEE ON INTERNATIONAL CAPITAL MARKETS OF THE NEW YORK STOCK EXCHANGE, INC.

My name is Robert V. Roosa and I am Chairman of the New York Stock Exchange's Advisory Committee on International Capital Markets as well as a partner in Brown Brothers Harriman & Co., a private banking firm located in New York City.

I appreciate the opportunity to appear before the Senate Subcommittee on International Finance and Resources to present the Advisory Committee's views on the desirability of eliminating the withholding tax on dividends and interest paid to foreign investors on their portfolio investment.

UNITED STATES NEEDS ADDITIONAL FOREIGN CAPITAL INFLOWS

We believe it is in the national interest to take all practicable steps toward encouraging the freer flow of capital among nations. But in addition to that broad objective, the United States now has a strong direct interest in reducing any obstacles to portfolio investment in this country on the part of foreigners.

If the economy is going to be physically equipped to produce anywhere near the potential of its manpower, then enormous amounts of capital will have to be secured in the years ahead. We need foreign investment as well as our own savings to create the jobs that can push unemployment below the 7% or 8% levels that so many now take for granted—and to keep the fires of inflation from being fueled anew.

Indeed, the pendulum has swung. Having relied heavily in the past on our investment in other countries to create those markets for U.S. exports that produce jobs and incomes for Americans, we now also need increased investment from other countries to help build the plants and equipment so necessary to keep this country productive, competitive, and fully employed.

One step Congress can take to support this change in our need for capital from abroad would be to eliminate the withholding tax on interest and dividend income on foreign portfolio investment in the U.S. In our view, the present tax discourages foreign investment at a time when it should be encouraged. The tax produces comparatively little revenue for the Treasury, both on an absolute and relative basis, especially when the costs of collection are taken into account. Indeed, the net gain to the economy from repealing this tax—in terms of increased job opportunities and higher incomes—would more than offset any loss to the Treasury.

One other tax issue in this area is, at least in immediacy of timing, even more urgent. That concerns interest on non-official foreign bank deposits held in this country which are "not effectively connected with the conduct of a trade or business within the United States." Such deposits have for years been wholly exempt from U.S. income tax, under the very same principle that underlies the case I am now making for extending the exemption from withholding to bond interest and stock dividends. Such deposits now aggregate many billions of dollars; indeed, an estimate by the American Bankers Association put them at $6.5 billion in 1973. But their tax exemption is scheduled to expire at the end of this year.

The threat of expiration means that deposits of ten months' or more maturity cannot now be made with assurance of their nontax status; nor can maturing deposits be confidently renewed for terms beyond the end of 1976. It is consequently of extreme importance that this reversal of an existing tax treatment be avoided. While I am here primarily to urge action that would make additional investment in the U.S. more attractive, I would be remiss if I were not to stress the need for action that would help to keep deposit funds here that have already flowed in under the benefit of tax exemption.

THE WITHHOLDING TAX DISCOURAGES FOREIGN INVESTMENT

The present withholding tax acts as an impediment to foreign portfolio investment. Under present law, a 30% tax is imposed, at the source, on the gross amount of dividends and interest paid to foreign investors. Though tax treaties modify this rate somewhat (see Table attached), the basic U.S. rate is still higher than in many other industrialized nations. Most importantly, the U.S. does not have tax treaties with the world's major source of potential investment capital—the oil-producing states of the Middle East. This factor alone has played a major part in diverting funds away from the U.S. capital markets. Simply put, investors in these countries can do better elsewhere, as the 30% withholding tax sharply reduces the net return on their portfolio investments. And for the most part, they would prefer portfolio investment in order to avoid any implication that they wish or intend to acquire controlling interests in American enterprises when they look for earning assets here.

The U.S. withholding tax has clearly been a factor underlying the relative lack of participation in the U.S. capital markets by the OPEC countries. In this connection, a recent Treasury Department study indicated that the U.S. share of such investments fell from 19% in 1974 to 15% last year. While OPEC investments in U.S. equities did rise in 1975—to roughly $1.4 billion vs. only $362 million in 1974—this sum still amounted to only 3.3% of the estimated $42 billion pool of OPEC investable funds. And that increase largely occurred, as I mention again later, in response to administrative relief from withholding granted by an IRS ruling to a particular type of governmental institution. Even so, the United States has received a relatively small commitment to the world's largest and most liquid securities market.

To the extent that the present withholding tax reduces the yield on U.S. corporate securities held by foreigners, then it is little wonder that such investors limit their participation in the U.S. securities markets.

ACTIONS TAKEN BY OTHER COUNTRIES

Other countries have moved aggressively to attract foreign capital by reducing their withholding tax rates. With the exception of Germany, none of the Common Market countries has a withholding tax on interest; and among themselves, withholding on dividends is being eliminated. Japan, in legislation enacted on March 30, 1974, exempted from income taxation interest on foreign currency debt securities issued by Japanese corporations to nonresident investors. The Canadian government has called for an exemption from the normal withholding tax on interest paid to nonresidents on Canadian public and private debt securities. In its Budget Report, it was indicated that "The proposed relief from withholding tax is intended to increase the flexibility of Canadian business to plan long-term debt financing and facilititate access to funds in international capital markets." Many observers believe that enactment of this legislation has played a role in the recent rise of the Canadian dollar.

The German experience with withholding taxes provides confirmation, though in reverse, of the impact that withholding taxes can have on foreign investment flows. In 1969, when the deutsche mark was strengthening markedly and investment funds were flowing in, the German government levied a withholding tax on foreign-owned German bonds in order to reduce foreign inflows of capital. And the withholding tax did help to discourage foreign demand for German debt securities. It appeas a reasonable deduction that the absence or elimination of such taxes will encourage foreign flows here at home.

NYSE STUDY ON U.S. CAPITAL NEEDS

Because of its concern over the long-term capital requirements and savings prospects of the U.S., the Exchange staff prepared a research report which is attached for the record.* In this report, Exchange economists estimated that the present saving potential in the U.S. economy through 1985—from all domestic sources—is something over $4 trillion. Over this same period, private sector capital demands are likely to reach a cumulative total of $4.5 trillion. In other words, the domestic savings capacity of the economy may well be insufficient to finance the capital required to provide adequate housing, modernize plant and machinery, develop domestic energy sources, and improve the enivironment.

The Exchange is not alone in focusing on the enormous financing needs facing this nation. Studies undertaken by the Treasury Department, the Brookings Institution, the National Planning Association, and the research departments of Data Resources, Inc., Chase Manhattan Bank, the General Electric Company and the Metropolitan Life Insurance Company confirm that this nation will be hard pressed to meet its future investment needs.

In our view, the withholding tax on foreign receipts from portfolio investments has become the wrong tax at the wrong time. In this period of long-term capital scarcity here, the U.S. should do all in its power to attract capital from abroad. The alternative, in effect, is to risk a vicious circle of reduced consumption (for the purpose of creating more capital) which in turn would reduce the incentive for domestic capital formation. The price of less capital formation is higher unemployment.

REMOVAL OF THE WITHHOLDING TAX WILL HAVE A MINOR REVENUE IMPACT

Total income from withholding taxes in 1971, the most recent year for which a full set of data is currently available, amounted to just over $211 million, or about 0.1% of total federal tax collections in that year. However, to collect this sum, an enormous amount of paperwork had to be generated. According to the Internal Revenue Service, over 636,000 detailed documents were filed with withholding agents in 1971 in order to administer the tax—on average, one lengthy form and internal audit for every $330 of tax receipts.

It should be noted that the ultimate tax loss would, in fact, be considerably less than $211 million, as a portion of this total represents inter-corporate dividends paid by subsidiaries to their foreign parent companies. If the tax on this inter-corporate dividend income were retained, the maximum Treasury loss would be considerably less. Unfortunately, no precise estimates of the magnitude of inter-corporate dividend flows are available to us.

The paperwork involved in collecting this tax also acts as a deterrent to investment in the U.S. For the foreign investor, not only must a form be filed in the U.S., but notification of taxes paid must also be made to his own government's

*The report was made a part of the official files of the committee.

tax service so that tax payments made to the U.S. can be credited against domestic taxes, and that often consumes more time and leads to troublesome if not costly delays in final settlement of taxes due and release of funds tied up in overpayments.

OVERALL GAIN TO THE ECONOMY FROM REPEAL OF THE WITHHOLDING TAX WILL BE SIGNIFICANT

On the basis of the evidence available, it appears that the overall effect of eliminating the withholding tax would be distinctly favorable for the U.S. economy. As greater income and profits are generated in the U.S. economy from expanded investment in this country, income tax receipts will increase on a direct basis. If a 15% pretax rate of return on invested capital is assumed—the median rate of return on invested capital is assumed—the median rate of return in the manufacturing sector—then every $1 billion of additional investment capital generated from abroad could eventually produce every year about $150 million in additional profits, resulting in approximately $75 million in additional tax revenues to the U.S. Treasury. A conservative estimate suggests that the annual gains from aggregate new foreign investment of between $2–$2.5 billion would more than offset any loss in annual tax revenues.

Many indirect benefits would also accrue as a result of the elimination of the tax. The added investment from abroad would have a beneficial impact on the U.S. balance of payments, probably exceeding for many years to come any additional outflows in dividend and interest payments to foreigners. Also of importance would be the improvement of the United States' position as the premier international financial market, as U.S. securities would become competitive with Eurodollar and Eurobond instruments which are not, of course, subject to withholding tax. Removal of the tax would result in a significant stimulation to investment banking and brokerage firms and commercial banks in New York and, to a lesser extent, elsewhere in the U.S. Because of their experience in providing issuing, clearing, market making, trustee, and other services, such firms are uniquely placed to take advantage of an increase in international activity in the U.S. financial markets. The resulting expansion in earnings and employment would also benefit the U.S. economy as well as the balance of payments.

ARGUMENTS FOR RETENTION OF THE WITHHOLDING TAX HAVE LITTLE MERIT

Though the House Ways and Means Committee approved repeal of the withholding tax in early October of last year, the full House subsequently voted against its elimination. In the floor debate prior to the vote in the House, a number of arguments were raised by opponents of repeal. Because the issues raised in the House debate may also come before this Committee, I believe it would be useful to examine the validity of various assertions made by opponents of the repeal legislation.

It was argued that repeal of the withholding tax would discriminate against American investors because they would continue to be subject to U.S. income taxes while foreigners would pay no tax on their U.S. investments. This was further embroidered to suggest that repeal of withholding would turn the United States into a "tax haven." However, this argument ignores the long accepted principle of international taxation—that individuals should be subject to tax in their own country of residence or nationality. It must be remembered, with respect to dividends, that they are paid out of corporate earnings that have already been fully taxed here. The form and extent of the double taxation that occurs when these dividends are paid out to stockholders is appropriately determined by the income tax procedures of the country in which that stockholder is resident. But the underlying income does not escape corporate tax here. And there is no valid analogy with the "tax haven" in which income is accumulated in a sort of "collection depot" to escape tax altogether.

To be sure, tax treaties already in effect reduce or eliminate U.S. taxes for foreign residents in some countries. Tax treaties with Switzerland, for example, have reduced the levy on dividends to 15% and on interest payments to 5%, but even then investors are left with the cumbersomeness of detailed reports and submitting claims for credits, which often take years to sort out. For the United Kingdom, and some 11 other countries, treaties have completely eliminated all withholding tax on interest payments. And, of course, the United States does not tax capital gains (nor credit capital losses) accruing to foreigners on stock or bonds. But all of this represents a patchwork of discriminatory treatment. Elimination of the withholding tax would end the discrimination among foreign investors on the basis of their domicile and the form of their investment.

In the House debate, it was further argued that repeal would hurt the American taxpayer because of the expected loss in revenue that would occur if the withholding tax were eliminated. However, as I have previously noted, the net revenue impact of repeal would very soon, perhaps within a year or two, be more than made up by increased revenues resulting from higher domestic incomes and profits generated by added foreign investment. Thereafter, we would continually enjoy a net gain.

The issue of "windfall gains" was also raised in the House debate. It was charged that repeal would provide foreign nationals with substantial tax savings and foreign governments with significant increases in tax revenues as they collected what was previously withheld here. However, to the extent that any windfall gains would remain with the taxpayer, they would not flow to his government, and vice versa. The critics cannot have both points—one excludes the other. To the extent that a foreign government does have an increase in its own revenues, and some may, that must I submit simply be accepted as one by-product of getting a better system overall. And the net gain in the United States from greater capital availability here would far exceed any "loss" here through the "windfall" route.

To be sure, as was argued in the House, the fact that much foreign investment is channeled through government agencies may to some extent limit the impact of repeal—especially as regards the OPEC states—but not appreciably and not for long. Foreign governments are only exempt for investments clearly "related to a governmental purpose." There is no blanket exemption and none that is automatic for a government corporation. Every foreign governmental entity claiming exemption from the withholding tax must prepare its case and apply for an exception from the Internal Revenue Service. Indeed, it was the final clearance of such applications that largely accounts for the 1975 upsurge of about $1 billion in equity investments here by certain OPEC countries.

What better evidence is needed that full elimination of the withholding tax would indeed assure a sustained surge of added investment in the United States? To the extent that our tax laws reduce the attractiveness of the U.S. capital markets, moreover, foreign investment will simply be attracted elsewhere. With the partial exception of Germany, every country in the Common Market now has more accommodative tax treatment for foreign investors than is offered here. It is therefore clearly to our advantage to move toward a more receptive posture as concerns the treatment of portfolio investment from overseas.

Two other arguments raised during the House debate also require comment. It was argued that repeal would reduce the bargaining power of the U.S. in future double taxation treaty discussions, and that added foreign investment inflows would place future burdens on the economy in terms of interest and dividend payments that would be due to foreigners. As to the first, anyone familiar with tax treaties—as I once was but can no longer really claim—could point to one-hundred-and-one details that provide all the leverage, or self-interset, that either side needs in working toward agreed arrangements of mutual advantage. The withholding tax lever as to dividends or interest is almost a trivial part of this larger set of detailed procedures and tax implications—ranging from customs practices to taxes on extractive industries and much more.

Regarding the future costs of foreign investment inflows, it is certainly true that for every dollar of inflow attracted in one year, we have to pay to the foreigner a continuous stream of interest or dividends over a longer period of years. However, such investment will increase the productive capacity of the economy. The resultant flow of additional income will more than compensate for any future payments to foreigners. In short, inducement of additional foreign investment is a sound national economic policy decision both for today and for the future.

CONCLUSION

The New York Stock Exchange joins with the Administration, the Treasury Department and other concerned groups in urging the repeal of the withholding tax on foreign portfolio investment. Elimination of the tax would promote foreign investment—adding to the nation's capital resources and buttressing the country's balance of payments. Furthermore, repeal would ease the way for U.S.-based multinational corporations to raise capital abroad for use here or elsewhere—reducing their demand on domestic sources of funds. Enlarged tax receipts from the additional profits and income generated by expanded foreign investment will more than offset any initial decline in tax proceeds from withholding—especially when the burdensome costs of collection are considered. Finally, the elimination of the tax should strengthen the U.S. capital markets and increase their importance in the international financial community.

U.S. WITHHOLDING TAX RATES ON INTEREST AND DIVIDENDS INCOME

[In percent]

Recipient	Dividends (Portfolio)	Interest
Nontreaty nations	30	30
Treaty nations:		
Australia	15	30
Austria	15	0
Belgium	15	15
Canada	15	15
Denmark	15	0
Egypt	15	15
Finland	15	0
France	15	10
Germany	15	0
Greece	30	0
Ireland	15	0
Israel	25	17.5
Italy	15	30
Japan	15	10
Luxembourg [1]	15	0
Netherlands	15	0
Netherlands Antilles [2]	15	0
New Zealand	15	30
Norway	15	0
Pakistan	30	30
South Africa	30	30
Sweden	15	0
Switzerland	15	5
Trinidad and Tobago	30	30
United Kingdom	15	0
United Kingdom overseas territories	15	30

[1] These rates are not applicable to Luxembourg holding companies.
[2] These rates are not applicable to holding companies unless certain elections are made.

Senator BYRD. I thank both of you gentleman.

I will ask Professor Musgrave of Northeastern University if she will make her presentation.

STATEMENT OF PEGGY MUSGRAVE, PROFESSOR, NORTHEASTEN UNIVERSITY, BOSTON, MASS.

Ms. MUSGRAVE. Thank you.

Senator BYRD. You perhaps would want to give a summary and then your formal statement could be submitted for the record.

Ms. MUSGRAVE. Yes.

Senator BYRD. You may proceed in any way you wish.

Ms. MUSGRAVE. Mr. Chairman, I would like to thank you for this opportunity to state and to explain my position in opposition to the exemption of the withholding tax on foreign portfolio investments.

I would like to give a brief summary of my reasons for opposing this proposal.

First, it is a widely accepted principle in international taxation that the country of source of income should be allowed a reasonable tax share in the income arising in its borders and accruing to investors abroad.

In fairness to its own domestic taxpayers, who must ultimately bear the revenue cost of this proposal, the United States should not surrender this claim.

This is particularly the case for interest income on which the withholding tax is the only tax collected.

Second, the withholding tax has customarily been modified in tax treaties which the United States has negotiated with other countries and it has proved to be a key factor in the U.S. treaty negotiating position.

Without the tax, the position of the United States in bargaining for reciprocal tax concessions in future tax treaties is likely to be severely undermined.

Third, the principal beneficiaries of the withholding exemption would be private portfolio investors from those countries with which the United States has no tax treaty, largely the oil producing countries and the less developed countries of Latin America and elsewhere.

The exemption in effect would put the United States in a position of being a tax haven to these investors and of encouraging capital flight from the less developed countries.

It is noteworthy in this connection that when the United States was recently in the process of negotiating a tax treaty with one such developing country, the latter requested the United States not to reduce or eliminate its withholding tax for fear of encouraging capital outflow from its own borders.

Furthermore, I believe that elimination of the exemption would discourage extension of U.S. tax treaties with these countries.

Fourth, those portfolio investors resident in countries with well developed income taxes are usually able to credit the U.S. withholding tax against income tax in their own countries, thus completely or very largely offsetting any extra burden occasioned by the tax.

In such cases, removal of the withholding tax simply results in a transfer of revenue from the United States to foreign treasury without much effect on the investors' own tax burden.

It is only for investors from countries with weak or nonexistent income taxes that removal of the withholding tax would represent a substantial reduction in their overall tax burden.

But I do not believe, Mr. Chairman, that the U.S. taxpayer would take very kindly to assuming the revenue cost of the withholding tax exemption for those foreign investors from countries which either do not tax them at all or, if they do so, do not provide the customary foreign tax credit.

Fifth, arguments made on behalf of the exemption largely run in terms of the need to make portfolio investment in the United States more attractive to foreigners and particularly that financed by petro-dollars.

The economic case for increasing the inflow of such funds, much of which is apt to be of a volatile nature, is not a convincing one, especially in view of the sizable revenue cost.

Retaliation by other capital importing countries via competing tax concessions must be allowed for, in which case the gains must be modest.

It is to be noted that although a number of smaller countries now offer a unilateral exemption on some interest payments paid abroad, others such as Germany, Canada, and the United Kingdom do not, but are likely to tip in this direction if the United States should follow the example of other smaller countries.

Sixth, the United States removed the interest equalization tax and other restraints on its own capital outflow on the grounds that in a regime of flexible exchange rates such constraints were no longer needed for balance of payments reasons.

Consistency, it seems to me, requires that similar reasoning be applied to foreign portfolio inflow to the United States, thus leading to the conclusion that tax concessions are no longer required under a flexible exchange rate system.

Furthermore, and perhaps more important, it would seem to me to be a misuse of the tax system, to give tax concessions to capital inflow at the same time as tax preferences are available to U.S. investment outflow.

Finally, and in my view most importantly, the exemption is likely to add further fuel to what is developing as a growing worldwide tax competition for international capital.

In the process, the equity and integrity of income taxes in many countries of the world is being undermined and the tax collected on investment income, particularly the corporation tax, is undergoing rapid attrition.

The United States played a large part in this tax competition when it introduced DISC, a tax concession which was followed by retaliatory tax incentives to domestic investment in a number of other countries.

The withholding exemption would, I believe, be followed by similar tax reductions in other countries.

The United States should exert leadership in this area to head off what may prove to be a continuous and self-defeating cycle of tax concessions to international capital.

Thank you, Mr. Chairman.

Senator BYRD. Thank you, Professor Musgrave.

In both points five and seven of your presentation, you mentioned competing tax concessions.

Ms. MUSGRAVE. Yes.

Senator BYRD. What went through my mind in listening to that is whether it would be similar to a situation that I will mention in a moment.

About 15 years ago I was chairman of the Virginia Advisory Commission on Industrial Development. So long as I was chairman, which was 5 years, I insisted that we not give tax concessions and tax advantages to companies coming into Virginia.

We would treat them fairly but they would not get any special tax treatment in order to encourage them to come into the State.

I felt for one reason it was unfair to the companies already in the State, but for another reason: When one State starts making concessions, then another State ups the ante.

I think you have that all over the United States now. I haven't kept up with it in detail recently, but I think that is about what has happened.

So, you really don't gain anything by it.

I gather what you are saying in your statement is that on an international scale, you get about the same situation. Is that it?

Ms. MUSGRAVE. Yes. Although, I would say that the dimensions are apt to be much greater on the international scene.

I think what you say is quite correct, Mr. Chairman. I think it is a very good analogy, but I do think that in the international context the problem assumes even greater proportions.

Senator BYRD. Would either Mr. Walker or Mr. Roosa care to comment on that?

Mr. WALKER. I don't know that the analogy really lies in that direction, Mr. Chairman.

I don't see that this is a competition of a tax incentive or a tax haven, as the example you put in your statement.

Rather, it strikes me as a removal of impediments to the free flow of capital which, if allowed to flow and seek its own level, would find its investment media in whatever the desirable yield potential would be for the investment.

Thus, for example, the investment of money in equities for industries in this country would have the following effects, it seems to me.

It would provide the additional capital needed to improve the degree of productivity of that enterprise in this country that not only produces the jobs and so forth associated with it, but it also produces income from that enterprise which indeed is taxed in the United States.

There is no preference in that sense of the word at all. The investor from abroad is thus spared the withholding tax, but is nevertheless in his own country subject to whatever that country's tax burden is on the yield from that investment.

By removing this impediment, it would have the effect of really treating all foreign investors from whatever country they come equally insofar as investment in our country is concerned.

It is not a piecemeal treatment of these foreign investors.

Senator BYRD. I had not seen my colleague, Congressman Fisher, til just this moment. I have just two additional questions in regard to Professor Musgrave's presentation and then I would want to call on the Congressman from Virginia.

In Professor Musgrove's presentation, number one, she says it is a widely accepted principle in international taxation that the country of source of income should be allowed a reasonable share of income arising in its borders but accruing to foreign investors.

Would Mr. Walker or Mr. Roosa comment on that statement?

Mr. ROOSA. It is not a principle that I have heard. I am not a professor of international or domestic finance, but I certainly have understood the opposite principle, in that this is a distinction between, for example, a tax haven and the situation we are talking about.

I would agree with the Secretary, for example, that this is not analogous to your condition in Virginia at all, because the basic corporate tax is still paid here so far as the dividends are concerned.

The point on interest has a different implication. With respect to the corporate position, the corporation pays full corporate tax here and then the domicile of the resident who receives the dividend, it seems to me, properly determines where he pays that which some people regard as double taxation in any event.

As you know, in many countries still you are taxed on one or the other, but not both, or at least you get a passthrough credit; therefore, I am just not aware of this principle.

It may be in some textbooks, but I have thought instead that the principle was the other way around, that it was the domicile of the taxpayer which determined the situs of the tax liability and that therefore corporations properly should pay taxes where they functioned—and do here—and that recipients, individuals of dividend income, are then subject to tax in their own country.

Senator BYRD. What is the Treasury Department's position on that tax principle?

Mr. WALKER. I think Mr. Roosa has expressed it the way I understand it, too, Mr. Chairman.

May I add one further thing on the subject of the tax credits?

Certainly, the utilization of a tax credit is designed to remove the double tax impact and to produce an aggregate tax liability that is no greater than our own domestic tax liability.

The fact is, I believe, that far fewer countries have a tax credit mechanism than do not have such a mechanism. Indeed, it is my understanding that of the 25 OECD countries, only six of them have a credit mechanism.

So, that the relief that is granted in that fashion isn't available. Otherwise, we have to obtain it by treaty.

Senator BYRD. I think Mr. Roosa has substantiated item three of Professor Musgrave's presentation, "The principal beneficiaries of the withholding exemption would be private portfolio investors from those countries with which the U.S. has no tax treaty, such as the oil producing countries."

Then, she said, "In the less developed countries, in Latin America and elsewhere."

Mr. ROOSA. I would modify it. If we eliminate the withholding tax, the beneficiaries are everywhere.

Senator BYRD. The principal ones should be in the Middle East, you indicated earlier.

Mr. ROOSA. I said the principal additional beneficiaries, apart from those with whom we have the tax treaties and who would then, of course, get the benefit of no tax.

Senator BYRD. Mr. Walker, according to a recent Treasury estimate, every $1 million foreign investment would produce $100,000 corporate tax revenue in this country.

What is the basis for that estimate?

Mr. WALKER. Mr. Chairman, was that $1 million or $1 billion?

Senator, I lose track of where the decimal point goes.

May I explain the rationale and how the number was arrived at?

Senator BYRD. Yes.

Mr. WALKER. I think every dollar that is invested from abroad is intended to produce yield. That yield in turn is subject to tax in this country.

The numbers that I have been familiar with are that if you assume a 15-percent yield on the investment, and roughly a 50-percent tax on the amount of that yield, you have an offsetting revenue gain as a result of that investment.

Senator BYRD. Thank you.

If all three of you could stay were you are, if you will, and I will ask Congressman Fisher to come to the witness table.

STATEMENT OF HON. JOSEPH L. FISHER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF VIRGINIA

Senator BYRD. The committee is very glad today to have my colleague from Virginia, Congressman Joseph L. Fisher, from the 10th Congressional District of Virginia.

Congressman Fisher is a noted economist. He has expertise in this field. He is a member of the House Ways and Means Committee.

It was his amendment which was adopted by the House of Representatives by a vote of 301 affirmative votes—I don't have the negative votes before me—which knocked out the Treasury Department proposal to eliminate the 30 percent withholding tax. Welcome Congressman Fisher.

Mr. FISHER. Thank you very much, Mr. Chairman. I would like to present a short statement on this subject.

Mr. Chairman, the House Tax Reform Bill, H.R. 10612, as reported to the Senate, retains the 30 percent withholding tax on U.S. portfolio income of foreign investors. I urge this committee also to retain this provision in its bill.

Repeal of the tax:

1. Would discriminate against American investors.
2. Would lose substantial revenue.
3. Would produce windfalls for foreigners; and
4. Would not promote capital formation in this country.

The withholding tax on foreigners' portfolio investments in the United States has been in effect for over 50 years. There is no reason to repeal it now.

The tax is imposed on dividends and non-bank-account interest, items on which Americans pay Federal income tax. To repeal the tax on foreigners would excuse them from paying taxes Americans must pay. This would not be fair. Why shouldn't foreign oil producers and other foreigners pay U.S. tax on their U.S. investment income when Americans must?

And why shouldn't foreigners pay U.S. tax on their U.S. investment income when Americans who invest abroad pay foreign tax on their foreign income? Most foreign countries tax Americans on their income from foreign securities.

Repeal of the tax would not only discriminate against the American investor, but also hurt the American taxpayer who would foot the bill.

Repeal would lose $165 million of revenue in 1976 and almost $400 million a year by 1981. From 1976 through 1981, the total revenue loss from repeal would be $1.9 billion. This loss would mean higher taxes for all Americans, including those with no investment income of their own.

If Americans would lose from repeal of the tax, who would gain?

Foreign investors and foreign governments. Like the United States, most foreign countries allow their citizens to offset taxes paid to other countries against taxes owed at home.

If a foreign investor pays little or no tax to his own country, repeal of the U.S. tax would allow him to pay no tax at all—a personal windfall.

Typically, however, the foreign investor receives credit for his U.S. tax; in this case, repeal of the U.S. tax would mean that he would still pay the tax—but to his home country instead of the United States. A national windfall.

In other words, by repealing our tax on income from U.S. securities, we would be foregoing revenues so that other countries could collect them. In effect, we would be "revenue sharing" with foreign countries. I believe in foreign aid, but I think this is too much.

Since repeal of the U.S. tax would not reduce overall taxes for most foreign investors, repeal probably would have little effect in attracting capital to this country.

Even if it did attract capital, foreign countries might be forced to lower their own taxes in self-defense, and then no one would win.

Moreover, making the United States into a tax haven country could tend to attract unstable money, for the same reasons as you, Mr. Chairman, were pointing out in terms of different States competitive granting tax advantages.

Long-term investors are interested primarily in asset appreciation, and the United States imposes no withholding tax on foreigners' capital gains.

The withholding tax on portfolio income has been in effect almost as long as the Federal income tax itself and, over the long run, the value of U.S. portfolio investment by foreigners has steadily grown.

For these reasons I urge the House, this subcommittee, and the Senate that the withholding tax on U.S. portfolio income of foreign investors be retained.

A vote to retain the tax will be a vote to preserve the tax base and a vote against giving windfalls to foreigners at Americans' expense.

Senator BYRD. Thank you very much, Congressman Fisher.

What was the House vote on your amendment?

Mr. FISHER. I don't have that in my hand, but it was a substantial margin.

Senator BYRD. How about the committee vote?

Did you have a vote in committee on that?

Mr. FISHER. It was a close vote. The committee, of course, voted to remove the withholding tax. Do you remember, Mr. Walker?

Mr. WALKER. It was about two to one, 25 to 12.

Mr. ROOSA. It was 25 to 12 in the committee.

Senator BYRD. Congressman, you say that repeal of the tax would discriminate against American investors. Would you amplify that?

Mr. FISHER. American investors have to pay income tax on dividends and interest. For most of us, the tax is prepaid in some way.

With the repeal of this tax on foreign portfolio investment in this country, they, the foreigners, would not have to pay this kind of tax.

This seems to me a straightforward and simple view of the matter.

Senator BYRD. Do you feel that repeal of the tax would not promote capital for our Nation?

Mr. FISHER. Not substantially, in my opinion, for the reasons that I set out in my short statement.

In the first place, we have long since adjusted to this feature in the Tax Code. It has been with us for a long, long time. Foreign investors have also adjusted to it.

If we repeal it, for many foreign investors they simply won't be able to take a deduction on their own income taxes in their countries and they will have to pay the tax to their home governments instead of to us.

They would not be motivated, if they are in this situation, to place their investments in this country.

Senator BYRD. Could I ask Mr. Roosa if he would comment on Congressman Fisher's statement and why shouldn't foreigners pay U.S. tax on their investment income when Americans who invest abroad pay tax on their foreign income?

Mr. ROOSA. In part, I am not sure that that is universally the case.

But, whatever it is, I think we really have to fit this in a historical context, which even goes back to the period before we started income tax.

Of course, at this time in the last century this country was a big capital importer and that is why we got the capital base from which our expansion soared till World War I and beyond.

By that time we have become so strong that we were a major capital exporter.

The pendulum has again swung. Regardless of what else we may like to do and because, too, in effect the forced saving imposed on the world by the OPEC action, which we are in no position to reverse, is concentrating substantial amounts of savings and investable capital in other hands at a time when the United States need for capital from outside is again great.

We don't have to have a reproduction of the way in which we have built the railroads on the basis of foreign capital and then repudicated the debts, but we are going to have to have substantial desirable capital flows, or the alternative, as I said in my prepared statement.

If we are going to do it and if we are going to create the capital base for the job expansion in a capital-intensive world, we are going to have to, for a time, have our version of what the Russians did.

That is, we are going to have to contrict consumption to create capital to provide the base for a fresh new surge in investment and expansion in this country.

This is only one small part of an adaptation to a fundamental change, in my view, in the pattern of this economy's relation to the world economy.

I think this is one way of reflecting the tax implication of it.

I don't think that what we propose doing is creating a haven. What we are doing, of course, is taxing the corporate income as it occurs here.

But we are assuring that in a world where other developed countries face some degree of the same problem we do and where virtually all of them have made tax adjustments or concessions which are comparable to the ones proposed here, we are putting outselves at least in a position of rough equality.

Senator BYRD. How do you respond to the view that repeal of the tax would discriminate against the American taxpayers?

Mr. ROOSA. There is a degree in which I don't think you can deny that there is discrimination with respect to interest.

With respect to dividends, it seems to me the basic points is that the tax is paid by the corporation before there is an after-tax income from which dividends can be disbursed.

There I know you can dance on the point of many pins of tax theory, but I see no problem at all with respect to the discrimination question there.

With respect to interest, Professor Musgrave is quite right, since interest is a deduction before tax, when interest is paid to foreigners who then would be exempt from tax, the situation is different.

I don't have any complete and neat answer to that, other than the fact that for many reasons interest of various kinds, including just the problem of computing discount that the Secretary mentioned earlier, interest has been regarded as taxable at the domicile of the recipient.

Moreover, we have built into the tax laws for years—we may lose it this December—the virtually permanent exemption for deposit interest.

There my principal concern in an imperfect world is that with deposit interest exempt and interest on long-term bonds subject to withholding, we are continually creating a situation which I regard as unsound financially.

That is the encouragement from their point of view of putting everything short. Therefore, I view this as equalizing the impact of the withholding burden among forms of interest so that at least we get more of the long-term investment and hopefully less of the volatility that both Congressman Fisher and Professor Musgrave have very rightly indicated is another problem.

We are never going to get anything that is ideal in all respects, but in the balance of alternatives, it seems to me the American taxpayer is most interested in how we can enlarge and expand this economy to provide both the jobs and the source of domestic income to keep both the Government and the people growing.

I think as against that, even the indicated tax loss of $400 million that the Congressman has mentioned has to be diagnosed a little.

Part of that tax is collected from intercorporate transfers. I don't know how much that is. The Treasury may know.

I suspect it is fairly large. That will not be affected by this change.

So, that if you make a deduction for the intercorporate transfers on the present figure, which is for withholding on dividends closer to 160 or 170—I don't know about the 400 figure—as far as that is concerned, it is possible that the intercorporate transfers accounts for one-third, possibly more.

Consequently, what we are talking about does become, in contrast with the potential gain in capital flows into this country, a deterrent.

The reason that Germany is now taxing withholding is because they want to keep capital out. It was making the deutschmark too strong. They are the only Common Market country that does it, and they do it for that reason, and they will take it off as soon as they feel they have a deutschemark they can live with that isn't breaking currency relations in Europe.

Another point that Professor Musgrave made, which is a valid one and needs more analysis before this is all finished, was that in a world of fluctuating exchange rates much of the previous case, the case that could have been made even 3 years ago, changes its nature.

Therefore, if there is a case, much of the basis for it has to rest on the grounds of encouraging capital investment in the United States that I have been adducing, and with a qualification that capital movements very often are going to be more signifiant factors in influencing exchange rate changes than are the movements of goods and trade.

Senator BYRD. This withholding tax on foreigners' portfolio investments has been in the Tax Code for over 50 years.

It seems to me the burden of proof is on the Treasury to indicate why this should be taken out. Is this the first time that Treasury has recommended repeal?

Mr. WALKER. It is my understanding that it is, Senator. I think there has been a cumulative effect, as Mr. Roosa has pointed out, in the way we have come to where we are.

There is an increasing need for an importation of capital or to have it more readily available to our expanding needs.

I think the origin of the withholding started when the reverse was true.

Senator BYRD. It has been in the Code for 50 years. That is a long time.

Mr. WALKER. As a matter of fact, also, due to the treaty network we have had and the exemptions and the exclusions that have been engrafted upon the system, the 30-percent withholding really is realistically more in the nature of a 10-percent withholding tax now anyway.

Senator BYRD. But Treasury has not previously advocated eliminating the withholding tax.

Mr. ROOSA. Mr. Chairman, the Treasury in steps has. Part of the case that I made before this committee and the House committee in 1962 for the removal of taxation on the interest of obligations owned by foreign central banks was related then to the emerging need to assure that we could hold in this country, under the exchange rate system we then had, the balances in dollars that foreign central banks were holding.

It was a part of the same pattern that has now reached the stage where what we want to do, in order to support the growth of the economy, is to provide a comparable stimulus across the board in terms of the flow of funds into corporate investment.

Senator BYRD. I think at that time Treasury recommended a withholding tax on dividends of U.S. citizens and also of interest.

Mr. ROOSA. That is a long story, too. What we had then, Mr. Chairman, in this effort which will always continue to try to find the best overall principles of equity in a rather tangled skein, what we were trying to combine that with, if you remember, was an ill fated but vigorous effort to control such other loopholes as the expense allowance practice in the handling of income of persons.

It was a part of a fabric of change which, I can't even at this minute remember all the pieces——

Senator BYRD. That recommendation, as I recall, put many restraints on business all over the country and damned near ruined the restaurant business.

Mr. ROOSA. It just about did. So, we sort of decided that in that case, whatever equity really implied—and it certainly implied what we were urging—there were so many established relationships and so many jobs involved that we made an administrative compromise in practice.

I think that is what is partly involved here.

Senator BYRD. I thank all of you very much.

Does anyone have anything to add to the comments?

Ms. MUSGRAVE. I would like to make two short comments in response.

One is to Mr. Walker's statement that it is necessary for us to eliminate the withholding tax in order to secure a free, unimpeded movement of capital around the world.

I look at it rather differently. It is the responsibility of the country of residence to insure that all its citizens wherever they invest are subject to the same rate of taxation to secure a free flow of capital around the world.

I think that if we follow his argument it would end up in the United States eliminating all taxes (including the corporation tax) on foreign investors from those countries where they were not subject to taxation.

It leads to a rather, I think, absurd conclusion that the taxation in the country of source should always be equal to the taxation in the investor's country of residence.

Mr. WALKER. I am afraid I don't follow the logic. But, that is why we have different points of view.

Ms. MUSGRAVE. The other point is that this emphasis on giving tax concessions to capital from abroad in order to increase the inflow of capital, the argument that the United States will have to rely more and more on the inflow of foreign capital, seems to me a rather curious argument to make at a time when we are exporting about 20 percent of our annual corporate investment abroad.

It would appear that this suggests we might look for other and better ways to increase capital formation in this country than to surrender our right to tax foreign investors.

Senator BYRD. Thank you, Professor.

Dr. Fisher, do you have anything you would like to add?

Mr. FISHER. The Treasury rests its case primarily on increasing the amount of foreign capital that comes to this country for investment purposes.

I think the equities argue in the other direction. I haven't followed the figures month by month, but I am not persuaded that over recent years there hasn't been a reasonably good flow of investment into this country, as well as from this country into others.

I am just wondering if the recent trends, what has actually happened, would argue that somehow or other we needed to give a further considerable new tax advantage to foreigners who might invest in this country.

Mr. WALKER. I believe this has been touched on, if I may comment, Mr. Chairman.

Senator BYRD. Yes.

Mr. WALKER. There has been obviously a flow of investment into the United States—Mr. Roosa has mentioned some of this previously—that has been stimulated or made possible through the Internal Revenue Service rulings. We have also pointed out the limitations of the flow that has come in that fashion.

The whole point of the proposal is to remove the impediments to a flow of capital across national borders.

While there has been obviously an outflow of some U.S. capital to foreign sources as the professor pointed out, we should for that reason say that we should seek to attract foreign capital here in lieu of what has gone out.

I think the free flow in the marketplace is the real test. To remove the stricture upon it by the imposition of withholding tax I think is the principal objective.

Senator BYRD. I thank all of you very much.

We have two additional witnesses, Prof. Hugh J. Ault of Boston College Law School and Tom Frost, the president of Frost National Bank in San Antonio, Tex.

Professor Ault, would you come forward?

STATEMENT OF HUGH J. AULT, PROFESSOR, BOSTON COLLEGE LAW SCHOOL, NEWTON, MASS.

Senator BYRD. Perhaps you would want to summarize your statement and the entire statement will be published in the record.

Mr. AULT. Thank you, Mr. Chairman. I am pleased to appear before the committee today. Several years ago I received generous support for my research activities under the Fulbright exchange program set up by you and your colleagues and I am delighted to make some contribution in return.

I have presented a statement but I would like to make a few additional points, if I may.

Senator BYRD. Your entire statement, without objection, will be placed in the record, and you may proceed to summarize.

Mr. AULT. I believe that the material that has been presented so far sets forth the basic arguments here. I would like to try to put those arguments in focus.

As Mr. Roosa indicated, the primary function of the proposed change in the U.S. rule is to attract capital on the theory that we have a capital shortage and need additional foreign investment.

That is a premise with which one could quarrel, but assuming that is true, what will this measure do to attract investment?

Let us focus on the people that it would affect. In the first place, as Congressman Fisher pointed out, for someone investing in the United States from a country which has a foreign tax credit mechanism the reduction in the U.S. tax will have no impact at all with respect to his after-tax rate of return on his investment.

He will simply pay more dollars to his Government and less dollars to our Government. There will be no change in the attractiveness of the U.S. investment to him in any way.

The United States will simply be giving foreign aid, in effect, to the other country which will collect more tax from its citizens than it could otherwise.

What about countries that don't have a foreign tax credit mechanism?

As to those countries, a number of them relieve international double taxation by exempting foreign source income but generally only on the condition that the foreign source income be taxed in the country of source. So, if the United States removes its withholding taxes on that income, again, the foreign country gains, the United States loses, and no investor has been encouraged to invest.

Who then will be encouraged to invest? One, people who don't pay taxes in their own country because they don't declare their income; and for whom the U.S. withholding tax is the only tax, or, second as Mr. Roosa indicated, investors from countries like Israel and other developing countries whom the United States should not be draining capital.

To put it another way, we shouldn't be attempting to attract to our investment market international tax avoiders and investors from less developed countries that need their own capital.

That is basically what this scheme is proposing.

The fourth category of potential investors is the OPEC countries. As was pointed out, these countries themselves are not subject to tax on income. Central banks of issue are not subject to tax on their income. There are some marginal definitional problems about the governmental functions of the foreign investor or the commercial functions of the central bank of issue, but the point is that they are fundamentally exempt from tax. The impact of the 1975 revenue ruling, which Mr. Roosa pointed out, cleared up some peripheral problems in that exemption. It seems to me really is letting the tail wag the dog to change a fundamental principle of U.S. income tax policy simply so that the OPEC countries can be absolutely sure that their income isn't going to be subject to tax.

That is especially significant against the background in which most foreign countries—in Europe, for example, France and Germany—do tax income when derived from portfolio investments by foreign governments.

So, the basic argument that this proposal will attract capital to the United States seems to me at best questionable.

Then the question is, even assuming you have accepted those arguments, what costs will this proposal bring with it?

There has been a lot of discussion with respect to the revenue loss and exactly what its magnitude is. It is clear, however the figures work out, that it will be substantial and that it will not flow primarily to foreign investors but to foreign governments.

Second, we have discussed the decline in the U.S. bargaining power by giving up the ability to impose the withholding tax.

There I think the Treasury has put the role of the withholding rates in a somewhat misleading light. They present it as if we were just tidying up some loose ends by eliminating withholding.

That is not true. Source jurisdiction is the primary jurisdiction in international tax law. All countries tax on a source basis. Sometimes they don't tax their own citizens on foreign source income, but in the evolution of a developing tax system, all countries use source as a jurisdictional base.

The United States has modified its source jurisdiction taxation and has reduced source jurisdiction taxation in treaty negotiations, but only in a negotiated setting, receiving a quid pro quo for U.S. investors in return for reducing its withholding taxes.

That is a second cost in addition to the revenue cost of this proposal.

Third, I think your instinct, Senator, that this would create the kind of tax war of tax concessions in the international context such as you saw in Virginia in the domestic context, is absolutely right.

The question really is, should the United States be a leader in contributing to an unstable international investment situation?

It seems to me by taking the first step in eliminating unilaterally our withholding rates that is clearly what we are doing.

Finally, again as Congressman Fisher pointed out, this provision, if enacted, would create substantial inequality in the treatment of U.S. investors with United States source income and foreign investors with the same income.

When Congress passed the Foreign Investors Tax Act in 1966, they set a reasonable balance between the appropriate taxation of foreigners investing in this country and U.S. citizens investing here.

Of course, we don't subject foreigners to a full range of our progressive income tax, but it is perfectly consistent with international tax principles and required by international tax equity that we impose a tax on foreigners who derive their income from the United States.

In summary, it seems to me that the benefits of additional capital investment which this proposal would bring are at best questionable.

The costs in terms of revenue loss, treaty bargaining, a tax haven war, and inequity to the U.S. taxpayers are very substantial.

We need a much stronger justification for the benefits that would flow to the United States to undertake this radical change in U.S. international tax policy.

Thank you.

Senator BYRD. Thank you very much, Professor Ault.

[The prepared statement of Mr. Ault follows:]

PREPARED STATEMENT OF HUGH J. AULT, PROFESSOR OF LAW, BOSTON COLLEGE LAW SCHOOL

No Capital Shortage.—The economic evidence with respect to the alleged "capital shortage" which United States business is said to be experiencing is at best inconclusive. The uncertainty of the economic data is certainly not sufficient to justify such a major change in United States tax policy.

Alternative Measures.—Even on the assumption that there does exist a meaningful shortage of investment capital, alternative methods of increasing investment capital are available. The House Bill itself, by increasing the investment credit and through other measures has provided financial stimulus for capital investment. In addition, the present tax preferences given U.S. businesses for their foreign investment could be eliminated or reduced if it is thought necessary to increase further domestic investment.

Measures Would Not Increase Investment.—The assumption behind the proposal to reduce the withholding tax is that by reducing the after tax rate of return for foreign investors, investment in the United States would be increased. This argument overlooks the fact that most foreign countries already provide their citizens or residents relief from the U.S. tax either through a foreign tax credit or by exempting the income from foreign tax if it is subject to tax in the United States. Thus, to eliminate the withholding tax would only result in a revenue loss (estimated at some $1.9 billion over the next five years) which would go directly to foreign governments rather than to foreign investors.

Inconsistent with International Tax Principles.—The basic principles of international tax law clearly allow a country to impose a tax on income arising from activities within its jurisdiction. There is no reason for the United States to unilaterally cede this clearly recognized international right. If the United States takes the lead in eliminating source jurisdiction taxation on portfolio investment income, it could lead to a "tax holiday" competition between capital importing countries to the detriment of all.

Inconsistent with U.S. Treaty Policy.—The U.S. has negotiated over forty conventions for the avoidance of international double taxation in which it has reduced or eliminated its withholding tax on dividends or interest flowing to investors resident in other treaty countries. But in all cases these reductions of withholding rates have been accompanied by a similar reduction in rates imposed by the treaty partner on its source income received by United States taxpayers. Since these foreign taxes would normally have been subject to the foreign tax credit, the United States in its treaty negotiations is in effect recouping the revenue which it loses from giving up the withholding tax on its source income by reducing the amount of otherwise creditable taxes which its citizens would have to pay to foreign government. Why should the U.S. unilaterally give up this revenue to these foreign governments with no *quid pro quo?*

Possibility of Abuse.—The freeing of dividends and interest from withholding taxes would give rise to a number of possibilities for international tax abuse. One can predict with certainty the formation of tax haven foreign corporations to invest in United States securities avoiding all U.S. and foreign taxes.

Equity With United States Citizens.—The Foreign Investor Tax Act, passed by Congress in 1966, sets out the basic U.S. policy with respect to the treatment of foreigners investing in the United States. Congress at that time was concerned with obtaining a proper balance between the taxes paid by our citizens on their United States income and those paid by foreigners on the same income arising here. The Act, consistent with international tax principles generally, taxes foreigners on their business income at the same rates as United States citizens and taxes them on their investment income at the flat 30% rate. Thus the Act recognizes that, while the foreign investors should not be taxed at full progressive rates on his U.S. source investment income, he should make some contribution to the U.S. revenue as part of the price for taking advantage of the investment opportunities in the U.S. To unilaterally eliminate this revenue and shift its burden to United States taxpayers would be inconsistent with the basic requirements of tax equity between United States and foreign investors.

Senator BYRD. The next witness will be Mr. Tom Frost, president of the Frost National Bank of San Antonio, Tex.

STATEMENT OF TOM FROST, PRESIDENT, FROST NATIONAL BANK, SAN ANTONIO, TEX.

Senator BYRD. Welcome, Mr. Frost.

I note that you have an interest in the State of Virginia in that you are a trustee of Washington and Lee University. So, I am doubly glad to welcome you to the committee today.

Mr. FROST. Thank you, sir; I appreciate the opportunity to be here.

I have a full statement which I would be happy to submit to you to be entered into the record. I will be guided by your suggestion.

I would be happy to summarize my views briefly.

Senator BYRD. I think that would be a very good approach. Your entire statement will be published in the record.

You can summarize your views as you see fit.

Mr. FROST. Thank you.

I am Tom C. Frost, Jr. I am chairman of the board of the Frost National Bank in San Antonio. I am here today to appear as a work-a-day banker, removed from the major financial centers to focus on a slightly separate issue that has been discussed for a good part of the morning.

That is on the section 1041 of the House bill 10612, which has to do with the exemption of interest on commercial bank deposits received by nonresident aliens not doing business in the United States.

This provision also exempts these deposits from estate taxes. I believe when something is proceeding satisfactorily for the benefit of all, that we ought to urge that it keep on moving in this direction.

I refer to the legislative action of the House, which has continued to recommend the benefit to this country of exempting these deposits from taxes, but also to emphasize that these deposits have been exempt from taxes since 1921 and the exemption was on a continuous basis until 1966.

Congress has considered the extension of this exemption on several occasions and has found it to be beneficial not just to the institutions who receive them or the depositors of those funds but to the economy of this country in the benefits that the consumers and the various business entities receive through these deposits flowing into the United States.

I speak with 26 years experience operating in this market and can say that these deposits are a stable and dependable source of funds for the extension of local credit.

I would like to point out that any lapse in this exemption would tend to see the outflow of these deposits. It would also tend to favor larger banks who have offshore operations.

Many of us did not have this option and if the tax-free status were not given, as it is now under the law, the larger banks with foreign branches could entice those depositors to place those funds in branches where this exemption is permitted.

At the current time these moneys would not be recycled into the domestic economy, but would be lost to the United States.

Senator BYRD. If I could interrupt at this point, as I understand it, then you feel that this provision of law, which has been in effect since 1921, you say, dealing with interest on bank deposits should be continued the way it has since 1921?

Mr. FROST. Yes, particularly on a permanent basis and without the temporary extensions.

What has occurred since 1966, Congress, I think, on three occasions has seen it to the benefit of the economy to extend the exemption.

In my experience and in talking with other bankers who have dealt with these depositors we found that these extensions have made the depositors more aware of the exemption and they have begun to affect the deposits in an undesirable way.

Before the exemption was permanent, the deposits flowed in and stayed on a permanent basis and could be treated in such a way.

Senator BYRD. When did it become nonpermanent?

Mr. FROST. In 1966.

The law was changed with an expiration date placed on the exemption. I think at least twice since then, perhaps three times, there have been extensions of that exemption.

We now note that depositors of these moneys are being very careful in their renewal of any time deposits and in our experience are carefully not extending them past December 31, 1976, when this exemption expires

We are urging that this committee agree to the actions of the House in section 1041 of H R. 10612 to return this exemption to the permanent status that it had from 1921 to 1966.

To summarize, we think there are about three things to happen. One, if the exemption lapses, there would be an outflow of funds. Little tax would be gained to the United States

There would be a loss to the domestic economy and there would be a restriction of available credit in many cities in Texas, in Arizona, and other nonfinancial centers, I must emphasize

It would, of course, be harmful to the balance of payments and, as I mentioned, would favor larger banks as opposed to the smaller banks, which do not have overseas branches.

If the law were just extended with an expiration date, these deposits then become more and more sensitive to this expiration

They are not as stable and in my opinion not as good a source for lending purposes.

If they are extended permanently, as I would urge you to recommend, it would be much better for the local economies and for the domestic economy of the United States.

Lastly, there is some urgency since, as I mentioned, these deposits are not being renewed past expiration date of the present law, December 31, 1976.

We urge that the provisions of the House bill be recommended and approved by the Senate to continue, as I have said, a good stable source of deposits which we have found have been beneficial to the domestic economy.

Senator BYRD. As I understand it, you are not taking the position on the elimination of the 30 percent withholding tax on dividends or on nonbank interest, you are concerned only with bank interest?

Mr. FROST. No, sir. I can't pretend to have any expertise or any experience in this.

I come to you as having 26-years experience in operating with bank deposits and can testify in favor of that. But, I cannot hold myself out to you as any expert in the other field.

Senator BYRD. You are dealing only with the bank interest and you think the Congress ought to make up its mind one way or the other what it wants to do about that and make it permanent?

Mr. FROST. Let me not be in that position with the Congress. Let me say in my experience the repeated extensions have made these deposits less a stable source and less desirable to being used to benefit our local economy.

Senator BYRD. It reminds me of what the Congress and various administrations have done with regard to the investment tax credit.

We put it on 1 year and take it off another year and put it back on and take it off again. It seems to me we ought to make up our mind what we want to do with it and then leave it alone, and then business ought to proceed.

Mr. FROST. It is encouraging that each time Congress has extended this I feel perhaps after we have made those repeated decisions it is time to return to the permanent exemption.

There is no one—I say no one—the majority of the thinking has not contested this as being desirable. I point out that the House action was consistent with this thinking and it is a bill that as it lies before you now does not have an expiration date.

Senator BYRD. Thank you very much, Mr. Frost.

When you go back to Washington and Lee, as you go by VMI, give it a salute for me, will you?

Mr FROST. Thank you very much, sir.

[The prepared statement of Mr. Frost follows:]

PREPARED STATEMENT OF TOM C. FROST, JR., CHAIRMAN OF THE BOARD, FROST NATIONAL BANK, SAN ANTONIO, TEX.

I am Tom C. Frost, Jr., Chairman of the Board of Frost National Bank of San Antonio, Texas. I appreciate the opportunity to appear before this Subcommittee in support of Provision 1041 of HR 10612 exempting from inome tax the interest paid on deposits by commercial banks to non-resident aliens not doing business in the United States. This Provision also exempts these deposits from estate taxes.

This Legislation is important not only to the individual banks in the major money centers and in locations bordering Canada, Mexico, and the Carribean who receive the deposits, but also to the economies servied by these banks. As evidence of the significance of this, The American Bankers Association in testimony before the House Ways and Means Committee in support of this Legislation on July 9, 1975, estimated these deposits at approximately six and one-half billion dollars. I personally can testify to the significance of these deposits to the economy of San Antonio and South Texas. During my 26 years of banking experience in this market and through conversations with bankers in other areas such as Florida, Arizona, and other money centers, I have observed that these deposits have been a good stable base for the extension of credit to domestic customers.

This exemption from Taxes has been in effect since 1921 and was on a permanent basis until 1966. For the last ten years Congress has reognized repeatedly the benefit of these funds to our domestic economy and the need to maintain this exemption to protect this source of deposits by several extensions of the law.

Previous Congressional action is consistent with the conclusion that these deposits would not remain deposited with domestic banks in the United States without this exemption since other countries whose banking systems and economies are attractive to the potential depositors do grant similar exemptions. I refer to the United Kingdom, Canada, the Bahamas, Switzerland, Belguim, Germany, and the Netherlands as examples. Legislative action has supported the position that if the normal withholding taxes are extended to the interest earned on these deposits and estate taxes are levied on them upon death of the depositor that a significant amount of these deposits would leave this country and their benefit would be lost to us. In considering the extention of this law on previous occasions, Congress has also concluded that the outflow of these funds would cause a significant adverse affect on the balance of payments.

Ten years of repeated extensions have caused the depositors of these funds to be aware of these expiration dates. These deposits are now more sensitive than before to this exemption from taxes. Our bank has had direct experience with depositors who are carefully renewing their time deposits to mature within the present expiration date, December 31, 1976. In conversations with other bankers, similar experiences are occurring. It can be seen that a good and continuous stable deposit source has been affected adversely. Many depositors are carefully reconsidering the redeposit of these funds because of the expiration of this law. These monies then must be treated in a different light by the bankers who receive them. We in San Antonio and many banks in Texas have had a stable and normal source of funds from citizens in Mexico and have used these deposits to finance needs in the local economy. Under the present circumstances with the exemption from taxes on these deposits not on a continuous basis, we may have to look upon them as less permanent and stable. Thus they might not be used for the same long-term beneficial credit purposes if the exemption from taxes is not made permanent.

It is my opinion and the opinion of many other bankers involved in dealing with these funds that little additional revenue, or none at all, may be gained by taxing this source. First, a significant amount of the deposits would leave and would not be subject to any tax whatsoever. Secondly, the banks which handle these deposits could not gain a profit on those deposits which were withdrawn thereby reducing the taxes which might be paid by the recipient bank.

Next, any jeopardy of these funds penalizes the smaller banks without offshore operations to a greater extent thean those larger banks in the major money centers who could entice their depositors to transfer these funds to a foreign branch in a country which does grant the exemption on a continuous basis. Foreign branch funds currently are not recycled to the domestic economy but are lost to the United States. The result would be an inequity favoring the larger banks.

It is my understanding that this committee may be asked to consider a proposal to exempt from taxes the income from certain other portfolio investments such as stocks and bonds held by nonresident aliens. I would like to point out that my remarks are directed to the making permanent an exemption which has existed since 1921 on the passive and short-term vehicle of commercial bank deposits only.

I should like to submit to you for your records as additional information in support of Provision 1041 of H.R. 10612 a letter dated November 28, 1975, from Max Mandel, Chairman of the Executive Committee of the Laredo National Bank, Laredo, Texas, to Senator Russell B. Long, Chairman of the Finance Committee.

In conclusion, I ask that you agree that Provision 1041 of H.R. 10612 is beneficial to the general domestic economy of the United States and that this Provision be adopted by the Senate as passed by the House so that the exemption is on a permanent basis without an expiration date. I would also respectfully suggest that reasonably prompt action is needed innse the present exemption expires December 31, 1976. At this time banks are experiencing a reluctance on the part of depositors to extend time deposits to mature after this date.

I will be happy to attempt to answer any questions or obtain any additional information which you might desire. Thank you for the privilege of appearing before you.

THE LAREDO NATIONAL BANK,
Laredo, Tex., November 28, 1975.

Senator RUSSELL B. LONG,
Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: Sometime during the next few weeks I presume that the Senate Committee on Finance will begin hearings on the tax reform bill that is now in the House. The bill reported from the Ways and Means Committee (HR10612) includes a provision (Sec. 1041) to make permanent the present exemption from income tax on foreign deposits held in U.S. banks. Under the present law the exemption would expire on December 31, 1976.

In my brief discussion with you of this matter on October 9, you indicated your general agreement with the desirability of extending the exemption, but I believe you were not certain whether the law should be made permanent or merely be extended for another short term. In this letter I would like to summarize some cogent reasons why the extension, if made permanent, would be more beneficial not only to the state you represent, but to the entire nation.

Since the early days of the income tax, Congress has rcognized the desirability of giving special treatment to foreign deposits. From 1921 to the enactment of the Foreign Investors Tax Act of 1966—almost a half century—the exemption was permanent, for Congress felt it was advantageous to our economy to encourage deposits of foreign funds in U.S. banks. For the past nine years, since the exemption was placed on a temporary basis, it has been evident that the banks cannot utilize foreign deposits for lending purposes as beneficially as they could if the exemption were restored to a permanent one. The uncertainty of the exemption extension has caused most bankers to view the deposits as "hot money" and therefore money that cannot be used for socially desirable long term loans such as home loans and term loans to small business; nor can the deposits be prudently used to invest in municipal bonds, Federal Home Loan bonds, and other intermediate term bonds. An important part of our loans and those of the New Orleans banks are made in the export-import business, and to finance the export of U.S. made goods. Some of these are term loans (3 to 5 years) and we could do a better job in this field if we were not concerned about the loss of foreign time deposits due to the lapse of the exemption, and subsequent mandatory liquidation of assets to adjust to the deposit run-off.

In addition, I would like to cite the following reasons as briefly as possible why the exemption should once again be made permanent:

1. The exemption from income tax of deposits in foreign branches in U.S. banks is covered by a different section of the Code which continues to provide for a permanent rather than a short term exemption. I am sure you will agree it is unfair to give this special benefit to those banks large enough to establish overseas branches. There are no Louisiana banks with foreign branches, and very few Texas banks. As you know, those banks with foreign branches are headquartered in New York, Chicago, San Francisco, and other money centers. In addition, deposits made in foreign branches are seldom brought into the U.S. economy for loans and investments, because they are loaned overseas in the Eurodollar market. Permitting the exemption on deposits in foreign branches of U.S. banks to remain permanent while the exemption on foreign deposits in domestic banks is temporary is unfair to those banks who cannot or have not established overseas branches, and gains little for our domestic economy.

2. Deposits of foreign governments and foreign central banks in U.S. banks have been, are now, and probably will remain totally exempt from U.S. tax. There have been some persons, including members of Congress, who advocate the discouragement of investment in the United States by petroleum exporting nations and their citizens. Their arguments may have merit with regard to certain direct investments, but it is likely that the Treasury and Congress will permit and encourage all foreign governments and central banks to purchase Treasury securities and keposit dollars in U.S. banks.

The banks in Louisiana, Texas, Arizona, Florida, and numerous other states do not have significant deposits of foreign governments and central banks; they are mainly from individuals who desire to take some of their savings out of their own country in order to spread the risk by placing these funds in another currency and in other banks. For many years, U.S. banks were favored with most of these deposits in dollars. Now some of these funds go to Canada and Europe. It is to our national best interest to continue our role as the banking center of the world and maintain the dollar as the world's most stable currency.

Texas and Louisiana banks have foreign deposits almost entirely from Mexico and Central America; they are from individuals who have come to our cities as tourists, to enter our medical clinics and hospitals, to make purchases, to engage in export and import trade, and to transact business of various nature. The funds they deposit have been used by the banks for consumer and business loans in our two states, and New Orleans bankers have agreed that these deposits, like those in Laredo and other Texas cities, have done much to enhance the economy of our two states.

3. I recognize the desire of some members of Congress to keep legislation which needs frequent review on a temporary basis so that it can be studied from time to time. However, I am sure that when a provision of law has stood the test of time and its permanency becomes desirable. it is advisable that such provision be restored to a permanent status. It must be your desire to make temporary legislation permanent when you feel that constant reexamination of it in the future is not worth the time that you must devote to it, and the risks of inability to extend the provision in time, when such extension is desirable.

In this particular case, the danger exists that in some future year, when the exemption is about to expire and most members of Congress once again desire to extend it, the provision would be part of a larger bill that is controversial, and because of a filibuster, or a Presidential veto, the exemption would be permitted to lapse. Although the large money center banks could probably have their deposits moved to their foreign branches and remain there until the exemption is restored, most Louisiana and Texas banks would not fare as well. Since their deposits are from individuals who will transfer to banks in foreign countries or to foreign branches of United States banks, it will be difficult if not impossible for the smaller banks to persuade these former customers to return. During the time that we have devoted to this matter, I have not met an individual or group that opposes the permanent exemption. I have, however, during that same period of time, received numerous inquiries from depositors worried about the possible expiration of the exemption. I hope you will agree, therefore, that we have a provision that deserves the permanent status that most provisions of the Code enjoy.

Some might argue that repeal of the exemption will result in substantial revenue for the U.S. Treasury. From my own personal experience, I would reject this argument because I believe foreign investors would seek other havens for their money. Another false argument is that such a tax is equitable. Equity would not be served if those depositors desiring the reputation and credit of U.S. banks because of their confidence in U.S. institutions would merely place these deposits in the overseas branches of large banks. As a matter of fact, it is probable that tax revenues are increased rather than reduced, due to the earnings of banks resulting from the foreign deposits.

If you will assist in passage of this measure, I believe you will have played a role in allowing Louisiana and Texas banks to be competitive in their solicitation of foreign deposits and for this reason will have greatly helped the economy of these two states.

With best wishes,

Sincerely,

MAX A. MANDEL.

EXPLANATION: EXTENSION OF EXEMPTION FROM INCOME TAX OF FOREIGN DEPOSITS IN UNITED STATES BANKS

I. PRESENT STATUTE LANGUAGE

Sections 861 (Income Tax) and 2104 (Estimate Tax) of the Internal Revenue Code of 1954, as amended, provide special rules for treatment under the income tax and the estate tax of U.S. bank deposits, and the interest thereon, of foreign persons (which include non-resident alien individuals and foreign corporations). Under Sec. 861 (see attached) which describes income from sources within the United States, the interest on U.S. bank deposits which is paid to foreign persons, and which is not effectively connected with the conduct of a trade or business carried on within the United States, is specifically excluded from treatment as U.S. source income, and, therefore, is not subject to United States income tax, nor to withholding. The same rule applies to the account itself for purposes of the estate tax, i.e., the non-resident alien individual's bank account in the U.S. is not to be considered property within the U.S. and, therefore, not subject to the estate tax if the interest thereon is not subject to the income tax under the special exemption described above. These exemptions are ,however, scheduled to expire on December 31, 1976.

II. ORIGIN OF PROVISION

In 1966 Congress provided, through the Foreign Investors Tax Act, that exemption from tax on U.S. bank deposits of foreign persons ought to be terminated, but not until December 31, 1972. The reason given was that this was clearly U.S. source income, but that to remove the exemption immediately would cause an adverse impact on our balance of payments. Congress therefore delayed the effective date of removal of the exemption until December 31, 1972, in order to have time to review the balance of payments situation and assess the impact of the removal of the exemption.

In 1969 the Congress again decided that the effective date of removal of the exemption ought to be extended through the end of 1975, since elimination of the exemption may have a substantial adverse effect on our balance of payments. Congress acknowledged that unless the law was extended, foreign persons may withdraw their holdings from the United States in anticipation of the elimination of the special treatment. Such outflow would further harm the balance of payments.

In 1974 the Congress recognized that this exemption "aided in attracting substantial amounts of funds to the U.S.," and extended the exemption for a one-year period of time, from December 31, 1975, to December 31, 1976. (See P.L. 93-625 and Senate Report 93-1357.) This was done in order to prevent an outflow of funds held as Certificates of Deposits with United States institutions.

III. NECESSITY FOR PERMANENT EXEMPTIONS

On three previous occasions Congress has decided that substantial balance of payments arguments required that the elimination of the exemption on interest on U.S. bank accounts of nonresident aliens be put off to a future date. The current cutoff date is December 31, 1976, and foreign depositors seeking to place or turnover time deposits in U.S. accounts are questioning whether the law will be extended. Clearly, the probability exists that these funds will leave the United States if the exemption is not extended or made permanent.

IV. CONCLUSION

H.R. 10612, the Tax Reform bill passed by the House of Representatives in 1975, would grant a permanent extension of the existing exemption from tax (Sec. 1041 of House bill).

There is a strong case to be made for permanent exemption. The uncertainty that now confronts the foreign time depositor as exemption expiration dates expire would be eliminated, thereby reducing the probability that funds will be withdrawn on the chance that extension will not be granted.

Therefore, Congress should permanently extend the exemption from U.S. tax of the interest on accounts held by non-resident aliens in domestic banks.

INTERNAL REVENUE CODE OF 1954, AS AMENDED

SEC 861. INCOME FROM SOURCES WITHIN THE UNITED STATES

(a) Gross Income From Sources Within United States.—The following items of gross income shall be treated as income from sources within the United States: (1) Interest.—Interest from the United States, any Territory, any political subdivision of a Territory, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, not including—

(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, . . .

[SEC. 861(c)]

(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 associations 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 (determined without regard to section 265) 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, 1976, subsection (a)(1)(A) and this subsection shall cease to apply.

Senator BYRD. The committee will stand adjourned.

[By direction of the Chairman, the following communication was made a part of the record.]

STATEMENT BY THE AFL-CIO

The AFL-CIO wishes to go on record in opposition to proposals to eliminate or reduce the 30 percent withholding tax on dividends and interest paid to foreign investors on U.S. source income. We also urge rejection of proposals to make permanent the present withholding tax exemption applying to interest income on U.S. bank deposits of foreign investors scheduled to expire on Dec. 31, 1976.

Those advocating the repeal of these provisions justify their position as a means to attract foreign capital, with a resultant benefit to the U.S. economy and the generation of jobs. In our view there is absolutely no reason to accept a blanket assumption that foreign investment in the U.S. creates jobs for Americans or is generally beneficial to the American economy. In fact, the type of investments that would be encouraged through eliminating the 30% withholding tax would, in the main, be speculative "hot" money that can and does move quickly and freely from country to country. Speculative capital that comes in to the U.S. temporarily as a result of tax preferences is not the kind of capital that creates jobs, increases productivity or contributes to the health of the economy. To the contrary, such flows merely add to instability and uncertainty.

In addition, most industrialized foreign countries allow their citizens to offset, through credits, taxes paid to other countries against those levied in their home country. Thus, in these circumstances repealing the U.S. tax merely amounts to a transfer of funds from the U.S. Treasury to the treasury of a foreign government.

Repealing the present 30% withholding tax would add a new tax preference costing the U.S. Treasury and American taxpayers $200 million or more annually. We see no reason why foreign investors who enjoy the security, protection and profit from investing in the U.S. should be exempted from making some contribution to this nation's taxes. American investors pay income taxes on their interest and dividend income to the U.S. government when earned in the U.S. And, except where waived by bilateral treaties, they also pay taxes to foreign governments on income earned overseas.

As Americans we have long criticized those so-called "tax-haven countries" which, in an effort to lure capital, grant special tax exemptions. The AFL-CIO does not feel that the U.S. should follow the example set by these countries. In fact, last year as part of the Tax Reduction Act the Congress eliminated some of the tax avoidance opportunities enjoyed by U.S. multinational companies that operate in the tax-haven countries.

[Whereupon, at 11:37 a.m., the subcommittee adjourned, subject to the call of the Chair.]

O