[COMMITTEE PRINT]

# INTEREST EQUALIZATION TAX EXTENSION ACT OF 1973 (H.R. 3577)

PREPARED FOR THE USE OF

THE COMMITTEE ON FINANCE IN EXECUTIVE SESSION

BY

THE STAFF

OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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## A. THE TAX IN GENERAL

The interest equalization tax, first made effective in the middle of 1963 and subsequently used in conjunction with the limitations on extensions of credit and direct investments abroad, is a part of the balance-of-payments program and is designed to reduce the outflow of dollars from the United States. This is accomplished by raising the costs to foreigners of obtaining capital in the United States to levels which approximate the cost of raising capital in their own countries.

The tax is imposed on U.S. persons which acquire foreign stocks and foreign debt obligations at rates which may be varied by the President between zero and a level which is roughly equivalent to a 1½ percentage point increase in the rate of interest foreigners would have to pay to obtain funds here. The President has the authority to prescribe a lower tax rate for new issues than the rate prescribed for outstanding issues. Under present law, the maximum tax rate in the case of stock is 22½ percent. A sliding scale of maximum rates is prescribed for debt obligations, ranging from 1.58 percent for obligations with a maturity of 1 year to 22½ percent for obligations with maturities of 28½ years or more. A tax rate of 22½ percent on an obligation with a maturity of 28½ years is approximately equal to the present value of a 1½ percent annual interest cost on the obligation. The lower rates for obligations with shorter lives achieve substantially the same effect. It is expected that the tax, although imposed on a buyer or lender, generally is passed on to the seller or borrower as an additional cost which must be recovered to make the loan attractive to the buyer or lender.

At the present time, the rates of tax prescribed by the President pursuant to his authority are the equivalent of a ¾-percent annual interest cost which in the case of stock and long-term debt obligations is a rate of 11¼ percent.

## B. EXPLANATION OF BILL AND SUGGESTED MODIFICATIONS RECEIVED BY COMMITTEE

*1. Extension of tax (sec. 2 of the bill)*

*Present law and House bill.*—Under present law, the interest equalization tax expires as of March 31, 1973. The House bill extends the tax for 15 months or until June 30, 1974. The Treasury indicates that the tax is an essential part of the U.S. balance-of-payments program.

*Suggestions received by the committee.*—The Treasury Department has suggested that the House provision be modified to extend the tax for 21 months, or until December 31, 1974, consistent with its proposal to terminate the tax at that time. However, the Securities Industries Association opposes the continuation of the tax beyond June 30, 1974, the date contained in the House bill.

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

*Present law.*—Present law contains a procedure which enables domestic corporations and partnerships to obtain foreign funds for use of their foreign affiliates in a manner which complies with the restrictions on foreign investment imposed by the Office of Foreign Direct Investment in the Commerce Department. Under this procedure, the domestic company or partnership elects to treat such an issue of debt as subject to the interest equalization tax. Where this procedure is elected under present law, the flat 30 percent (or a lower rate imposed by treaty) U.S. tax (generally imposed on interest and other payments by U.S. persons to foreign persons) does not apply to interest payments on debt where the election referred to above has been made.

*House bill.*—The House bill provides that in the case of debt where this election has been made and certain other conditions are met,[1] the value of the debt is not to be included in the U.S. estate tax base of the nonresident alien holder of the debt. The U.S. estate tax base of U.S. citizens or residents remains unaffected by this provision.

The Senate adopted an identical amendment to H.R. 7577, during the 92nd Congress. This provision was proposed by the Treasury Department for inclusion in this House bill, H.R. 3577.

*Suggestions received by committee.*—(a) It has been suggested that the effective date of this provision be April 1, 1971, the effective date of the Interest Equalization Tax Extension Act of 1971 which added the special election and source provisions to the law.

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(b) It has been stated that the interest equalization tax estate tax provision would have the effect of having corporations incorporated in foreign jurisdictions such as the Netherlands Antilles reincorporate in the United States in order to avoid existing local income taxes. It has been suggested that debt obligations of financing corporations incorporated in foreign jurisdictions, such as the Netherlands Antilles, that were issued before January 1, 1973, should not be eligible for the provisions of the House bill, which exempts them from U.S. estate tax. New issues of debt obligations would be eligible for the exclusion from U.S. estate tax.

Silverstein & Mullens for the Kingdom of the Netherlands—Netherlands Antilles

*3. Shipping companies in less developed countries (sec. 3(b) of the bill)*

*Present law.*—Under present law, the interest equalization tax does not apply to the acquisition by a U.S. person of stock or debt obligations of a less-developed country corporation. Among the foreign corporations which qualify as less developed country corporations are corporations which derive substantially all of their income from the operation of ships or aircraft registered in a less developed coun-

[1] These conditions are that the debt obligation when issued (or treated as issued) had a maturity not exceeding 15 years and when issued was purchased by underwriters with a view to distribution through resale.

try and whose stock is substantially owned by U.S. persons or residents of less developed countries.

*House bill.*—The House bill provides that this exclusion is to no longer apply to the acquisition of stock or debt obligations of less developed country shipping corporations. The less developed country exemption will generally continue to be applicable to nonshipping corporations which have significant operations within those countries.

This provision was proposed by the Treasury Department for inclusion in the House bill.

The House bill provides that this exclusion is to continue to apply to transactions generally which had reached an advanced stage prior to the date on which this proposal was made by the Treasury Department to the House Ways and Means Committee, January 30, 1973.

For example, under the House bill this exclusion continues to apply to acquisitions as to which before January 30, 1973, the acquiring U.S. person had taken every action to signify approval under the procedures ordinarily employed by that person in similar transactions (subject only to the execution of formal documents evidencing the acquisition and subject only to the customary closing conditions) and satisfied one of two conditions. One of these conditions is that the acquiring U.S. person must have sent to or received from the foreign issuer or obligor a commitment letter or other signed documents setting forth the principal terms of the acquisition. The acquiring U.S. person must have both approved of the acquisition and sent or received the requisite letter or document before January 30, 1973.

Another type of situation to which this exclusion is to continue to apply is where an acquisition of securities meets three conditions: (1) a registration statement was in effect with respect to the stock or debt obligation acquired at the time of its acquisition; (2) the registration was first filed with the Securities and Exchange Commission after January 29, 1973, or within 90 days prior thereto; and (3) no amendment was filed with the Securities and Exchange Commission after January 29, 1973, and before the acquisition which had the effect of increasing the number of shares of stock or the aggregate face amount of the debt obligations covered by the registration statement.

*Suggestions received by committee.*—Several suggestions for modification of this provision were received.

(a) It is stated that it is not uncommon for a U.S. person, such as a bank, to give its commitment to a U.S. company to enter into a financial lease of a vessel with the understanding that prior to the execution of the charter, the company will organize a wholly-owned less developed country shipping corporation to act as the charterer of the vessel. In such a case, the U.S. parent company usually sends or receives the commitment letter or other documents, instead of its less developed country shipping subsidiary as is required under the present House bill. Alternatively it has been suggested that the preexisting commitment language be amended to provide that the U.S. person acquiring the obligation may send to or receive the commitment letter or other document from either the less developed shipping corporation or its parent.

Edwards & Angell, Providence, R.I. for industrial National Bank of Rhode Island

(b) In another case it is indicated that it is a normal business practice of some businessmen to give oral rather than written commitments for financing the acquisition of ships (as discussed above, the House bill requires written commitments). Therefore, it has been suggested that in addition to the present preexisting commitment provisions contained in the House bill, it be provided that this exclusion continue to apply to an acquisition if it meets three conditions: (1) that prior to January 30, 1973, a request for a ruling under this exclusion had been filed with the Internal Revenue Service in connection with the transaction; (2) that prior to January 30, 1973, a majority of the U.S. persons financing the transaction had approved (or given a commitment to participate in) the transaction, either orally or in writing, subject to customary conditions; and (3) that the vessel to be acquired in the transaction is delivered prior to May 1, 1973.

Williams and Jensen for Gotaas-Larsen

(c) As discussed above, the House bill provides that the preexisting commitments exception generally applies if a commitment letter had been sent, subject to the execution of formal documents evidencing the acquisition and to customary closing conditions. Any transactions in which a U.S. person purchases from a foreign corporation a ship built outside the United States and leases it back on a bareboat charter to that corporation is subject to U.S. Maritime Administration approval. It has been suggested that the Committee Report make it clear that Maritime Administration approval of such a transaction is an example of a "customary closing condition" for purposes of the preexisting commitment rule. This approval is granted subject to fairly routine requirements (such as requirements the vessel not be made available to certain proscribed countries and that it not engage in trade prohibited to U.S. flag vessels).

Melrod, Redman & Gartlan for Greyhound Leasing & Financial Corporation

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(d) As explained above, the preexisting commitment provision exception to the removal of the less developed countries shipping exclusions requires that a commitment letter have been sent which sets forth the principal terms of the obligation.

It is stated that in at least one situation, a commitment letter extensively detailed a transaction providing a purchase option to repurchase a ship at the termination of the primary lease term for a specified dollar amount. However, it was subsequently recognized that Maritime Administration approval would be required if this option to purchase was ever exercised. Therefore, subsequent to January 29, 1973, the parties to the transaction negotiated an agreement which provided an option to the lessee to extend the primary lease term at a new rental exercisable only in the event the lessee exercises its purchase option, but the Maritime Administration refuses to accede to the sale of the vessel pursuant to the exercise of this option. It has been suggested that the committee report make it clear that such a subsequent agreement is not a principal term which has to be cited in the commitment letter.

Melrod, Redman & Gartlan for Greyhound Leasing & Financing Corporation

(e) It is stated that the function of a registration statement is to register the securities for sale in the manner described in the statement, and that any resales by initial purchases are evaluated independently to determine whether an additional registration statement, and that any resales by initial purchasers are evaluated in-
actions. It has been suggested that it be made clear that the acquisition of these resold securities is also eligible for the public offering rules contained in the House bill.

Davis, Polk & Wardwell for Smith, Barney & Co.

(f) As explained above, the preexisting commitment exception providing for the continuation of the less developed country shipping corporation exclusion only applies if the acquiring U.S. person has taken every action to signify the approval of the acquisition. It has been stated that in at least one transaction which was in an advanced stage at the time of the Treasury Department's proposal to the House Ways and Means Committee, January 30, 1973, the acquiring U.S. person succeeded to the interest of a person who signified this approval. (i) It has been suggested that the pre-existing commitment provision be modified to allow a predecessor in interest of the acquiring U.S. person to have signified approval of the acquisition. (ii) Alternatively, it has been suggested that the less developed country shipping corporation exclusion be amended to permit financing of ships ordered prior to January 30, 1973, so long as there is acceptance of full chargeability under the direct investment controls of the Commerce Department or the voluntary foreign credit restraint guidelines of the Federal Reserve System.

(i) (ii) Debevoise, Plimpton, Lyons & Gates for ITEL Corporation

(ii) American Committee for Flags of Necessity

(g) It has been stated that under the House bill, the acquisition of stock or debt obligations of a less developed country shipping corporation which owns ships manufactured in the United States will be subject to the interest equalization tax. Furthermore, refinancing of a loan which was previously exempt under the less developed country shipping corporation exclusion would also be subject to the tax. Therefore, it has been suggested that the tax not apply to this type of refinancing and that it not apply to loans for the construction or reconstrucion of ships in U.S. shipyards.

West Indian Shipping Co., Inc.

(h) It has been suggested that the proposed repeal of the less developed country shipping corporation exemption be deleted.

Singer, Levine, Singer & Todres

*4. Issuance of securities to raise funds for investments in the United States (sec. 3(c) of the bill)*

*Present law.*—Under present law, foreign issuers or obligors generally must use foreign source funds to invest in the United States because their stock or debt obligations are subject to the interest equalization tax if acquired by U.S. persons.

*House bill.*—In order to encourage foreign direct investment in the United States which provides jobs for American workers, the House bill provides for an exclusion from the interest equalization tax for the acquisition of new or original issues of stock or debt obligations for new or additional direct investments in the United States. However, in order for his stock or debt obligations to be eligible for the exclusion, a foreign issuer or obligor must satisfy the Treasury Department that he will meet certain requirements. Among these conditions are the requirement that at least 50 percent of the funds for the direct investment in the United States will come from foreign sources; second, that the investment will be for a minimum of a 10-year period; third, that during the 10-year period of the required investment no other investment in U.S. assets will be decreased; fourth, during the 10-year period, the issuer will comply with other conditions and requirements prescribed by the Treasury Department and made applicable to him; and fifth, during the 10-year period, the issuer will submit reports to the Treasury Department detailing such information as is necessary in order to substantiate the fact that the investor is complying with his commitment to make the direct investment. The exclusion only applies to new or original issues of foreign issuers or obligors who meet these conditions. The tax is imposed upon the issuer if he fails to live up to his commitment to make the direct investment in the United States. In addition, the issuer is subject to a 25-percent penalty if he willfully fails to satisfy his commitment.

This provision was proposed by the Treasury Department for inclusion in the House bill.

*Suggestions received by committee*—

(a) *Period of direct investment.*—In the case of the requirement that the investment in the United States be for a minimum of a 10-year period, it has been suggested that this minimum period is too long in those cases where the foreigner sells debt obligations with a maturity of less than 10 years. Therefore, it has been suggested that the minimum period of direct investment be for 10 years in the case of stock and the lesser of 10 years or the period remaining to maturity for debt obligations.

Sullivan and Cromwell for the International Finance Committee of the Securities Industry Association

(b) *Refinancing.*—In the case of the requirement that the new or original issue be one which was issued for the purpose of financing additional or new direct investment in the United States, it has been suggested that the new or original issue should also be allowed to be issued for the purpose of refunding or refinancing a previous issue which itself qualified for this exclusion if the foreigner can satisfactorily establish that this is the purpose of the new issue.

Sullivan and Cromwell for the International Finance Committee of the Securities Industry Association

(c) *Convertible securities.*—In the case of the requirement that the new or original issue be one which was issued for the purpose of financing additional or new direct investment in the United States, it has been suggested that the issue also cover the conversion of an issue, or the exercise of warrants, where the original issue qualified under this provision.

Sullivan and Cromwell for the International Finance Committee of the Securities Industry Association

(d) *Advanced ruling requirement.*—It has been suggested that the advance Treasury ruling requirement should be eliminated.

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(e) *50 percent participation requirement.*—It has been suggested that the 50 percent participation requirement be made more specific as to whether or not the foreign participation must be ratably applied to each class or type of security issue which produces funds for direct investment in the United States.

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(f) *Debt equity ratio tests.*—It has been suggested that the committee report clarify that the 50 percent participation requirement not be interpreted to affect the present Internal Revenue Service ruling policy with respect to debt to equity ratios of international finance subsidiaries.

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*5. Stock dividends by certain mutual funds*

*Present law.*—Under present law, a qualifying domestic mutual fund may elect to be treated as a foreign issuer with respect to any acquisition of its stock.

*Suggestions received by committee*—It has been suggested that these rules be changed to provide that a domestic mutual fund which has elected to be treated as a foreign issuer for purposes of the interest equalization tax will continue to be entitled to the benefits of the election although it issues a stock dividend to shareholders who have the option to receive a cash dividend.

Davis, Polk & Wardwell for The Japan Fund, Inc.

*6. Participating firms trading for their own accounts*

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

*Suggestions received by committee.*—It has been suggested that the statute be amended to clarify that a participating firm which sells securities for its own account and pays the tax may issue a valid confirmation. In such a case, it could pay the tax by the date it would have had to deposit the funds in a separate account if it had been acting for a customer instead of for itself. Under this suggestion, the 125 percent penalty would continue to apply to all tax avoidance cases.

Dunnington, Bartholow & Miller for J. R. Timmins and Co.

*7. Export credit transactions*

*Present law.*—Under present law, if a U.S. person leases property to a foreigner, the lease will be treated as a debt obligation for purposes of the interest equalization tax if it is entered into principally as a financing transaction. A domestic corporation engaged in this type of leasing to foreigners may be treated as having been formed or availed of for the principal purpose of obtaining funds for a foreign obligor. If the lessor borrows from a U.S. person to purchase the property subject to the lease, the lender is deemed to have acquired a foreign debt obligation from the foreign lessee. The lessor is not subject to the tax if the property was produced in the United States. However, the U.S. person lending funds to the lessor to purchase this U.S. export property is subject to the tax since the lessor may be treated as being formed or availed of for the principal purpose of obtaining funds for a foreigner. This is true even though the lease is an export lease and is exempt from the IET.

*Suggestions received by committee.*—It has been suggested that the rules dealing with export credit transactions (sec. 4914(c)) be amended to provide that a loan to a U.S. person where the proceeds are used to finance the acquisition of U.S. export property for leasing, as well as for sale, to foreigners be exempt from the IET.

Sherman & Sterling for First National City Corp.

*8. Funding of stock options and other issues of stock*

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

*Suggestions received by committee.*—(i) It has been stated that the present provisions relating to certain foreign corporations considered to be domestic issuers discriminates between employees who hold stock options of the same issuer, by exempting some option stock from the interest equalization tax while imposing the tax on others, solely on the basis of whether or not such stock was outstanding at the time of the original enactment of the interest equalization tax. It has been suggested that stock acquired by U.S. employees upon the exercise of their stock options be exempt from the tax if the stock is held of record by more than 250 shareholders on the corporation's last record date before the issuance of the additional shares. However, this exemption would only apply if the stock is issued pursuant to an option plan which is not transferrable other than by will or similar means and which is exercisable only by the U.S. employee during his lifetime. In no case would the exemption apply if the stock were issued to an employee who owns at least 5 percent of the stock of the corporation, nor would it apply if the options granted that year were with respect to more than one percent of the outstanding stock of the corporation. Such stock would include stock issued under a qualified stock option plan (under section 422) and under a nonqualified plan.

(ii) Another suggestion would allow the issuance of stock after November 10, 1964, if an interest equalization tax had been paid by a U.S. person on an earlier acquisition of these additional shares of stock.

(i) (ii) American International Reinsurance Company, Inc.
(i) Sherman & Sterling for Schlumberger Limited
(i) Syntex Corporation

*9. Certain domestic corporations treated as foreign*

*Present law.*—As explained above in the discussion of the IET estate tax amendment (number 2), if a domestic corporation elects to have its debt obligations treated as foreign and meets certain conditions, the interest paid on that debt will be treated as foreign source income. These foreign source rules are generally available in the following instances:

(1) Where the debt obligations are part of a new or original issue which when issued after April 1, 1971, had a maturity not exceeding 15 years.

(2) Where the election is made in respect of an issue outstanding on April 1, 1971, which, when issued, had a maturity not exceeding 15 years, and

(3) Where the election is made as a result of the assumption of the obligation of an affiliated corporation regardless of when issued. In this instance the date of the assumption is treated as the date of issue for purposes of measuring the 15 year maturity requirement of section 861(a)(1)(G).

*Suggestions received by committee.*—It has been suggested that the foreign source rule be made available to interest on debt obligations of a domestic corporation (one which formally was an 80–20 domestic corporation and which now wants to elect to have its debt obligations treated as foreign (a so-called "formed or availed of" corporation)), which at the time of the election had a remaining maturity of 15 years or less but when originally issued prior to April 1, 1971, had a maturity in excess of 15 years.

Bangor Punta Corporation

*10. Foreign corporations treated as domestic corporations in reorganizations.*

*Present law.*—Under present law, a foreign corporation whose stock is treated as domestic stock, can issue new stock after November 10, 1964, if all of the additional stock is issued in exchange for shares of a domestic corporation which is engaged in the active conduct of a trade or business immediately before the exchange. However, this rule does not apply if the stock is issued for the stock of a foreign corporation.

*Suggestions received by committee.*—It has been suggested that the rules relating to the issuance of stock for the acquisition of stock of a foreign corporation be amended to permit the issuance of stock as consideration for the acquisition of stock of a foreign corporation if immediately after the acquisition the issuer owns more than 50 percent of the stock of the acquired corporation. Alternatively, stock may also be issued as consideration for the acquisition of more than 50 percent of the assets of a foreign corporation. It has been stated that it is common for these acquisitions to be effected by using either stock or convertible debt obligations as consideration. Therefore, it has also been suggested that stock may be issued upon conversion of debt obligations, or in connection with the prior conversion of debt obligations, which were the consideration for the acquisition of stock or assets.

In any case, in order for these corporations to acquire other corporations in this manner, they must meet the following tests. The acquired corporation must be engaged in the active conduct of a trade or business before the acquisition. Its stock must have been widely held before January 1, 1973, and traded on a U.S. stock exchange. It must have had its principal office in the United States both on January 1, 1973, and on the date of the issuance of the additional shares. Additionally, the foreign issuer must have been actively engaged in a trade or business on July 19, 1963, shares of the class of stock must have been held of record by more than 250 shareholders prior to that date, and prior to the issuance of the additional shares the percentage requirements (65 percent or 50 percent) must have been met. Lastly the number of additional shares are restricted to a cumulative one percent per year.

Shearman & Sterling for Schlumberger Ltd.

*11. Other extensions of the treatment of a foreign corporation as a domestic corporation*

*Present law.*—Under present law, interest equalization tax does not apply to the acquisition of stock of foreign companies which on July 19, 1963, (the effective date of the original IET) was more than 65 percent U.S. owned by classifying the issuing companies as domestic corporations. Foreign corporations which have achieved more than 65 percent U.S. ownership since July 19, 1963, continue to be treated as foreign and the acquisition of their stock is subject to the interest equalization tax.

*Suggestions received by committee.*—It has been suggested that the rules classifying certain foreign corporations as domestic be expanded to include as domestic any foreign corporation which on its last record date before January 1, 1973, had more than 65 percent of its stock held of record by U.S. persons.

Bralorne Can-Fer Resources, Ltd.

*12. Foreign lending or finance businesses*

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

U.S. companies meeting these tests to elect to be treated as foreign corporations for purposes of this tax.

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

*Suggestions received by committee.*—

(a) It has been suggested that a U.S. corporation which would otherwise be primarily engaged in the foreign lending or finance business be allowed to make equity contributions to its foreign lending and finance subsidiary without being considered not "primarily" engaged in a lending or finance business (it cannot make a loan because of the thin capitalization rules of the Internal Revenue Service). Only foreign source funds may be used for this type of investment.

(b) Another suggestion received by the committee relates to the rule discussed above providing that in order for a corporation to be considered as primarily engaged in a lending or finance business, it may make only loans of 48 months or less. It has been stated that while this maturity was the trade practice when this provision was originally enacted, it is now the trade practice of regularly making loans for periods of up to 60 months. Therefore, it has been suggested that the 48-month rule be extended to 60 months.

James W. Riddell for Beneficial Corporation

*13. Interest equalization tax refunds*

*Present law.*—Under present law, an underwriter or dealer in securities which acquires foreign securities generally is subject to the interest equalization tax upon that acquisition. However, the firm is allowed a credit or refund of the tax to the extent the foreign securities are resold to foreigners. An interest equalization tax return is required to be filed by the firm for each calendar quarter during which it incurs liability for the tax. If the firm does not resell the foreign securities until after the due date for the quarterly return, it is required to pay the tax. Subsequently, when it resells the foreign securities to foreigners it may claim a credit or refund of the tax paid. However, under present law, the firm is not entitled to interest on a refund regardless of the length of time the Internal Revenue Service takes to process the claim for refund.

*Suggestions received by committee.*—It has been stated that if a firm purchases foreign securities in one quarter, pays the tax on these securities and then claims a refund in a subsequent quarter, the processing of the refund by the Internal Revenue Service has taken up to two years. It has been suggested that a firm in this situation be entitled to interest on a refund which is not paid within 45 days after the date on which the claim for refund is filed. This suggestion would incorporate a provision in the law with respect to interest equalization tax refunds which is currently in the law with respect to income tax refunds (sec. 6611(e)).

Shearman & Sterling for White, Weld & Co. Inc.

*14. Qualified lending and financing corporation (QLFC)*

*Present law.*—Under the direct investment exclusion of present law, a U.S. company may acquire tax-free stock of a foreign corporation in which it has at least a 10-percent voting interest. This exclusion is not available, however, if the foreign subsidiary is "formed or availed of" by the U.S. company to make otherwise taxable acquisitions of foreign securities. It can be argued that a foreign subsidiary which is engaged in the lending or finance business abroad is "formed or availed of" with the result that its U.S. parent institution would not be able to make a tax-free direct investment in the subsidiary. This situation also could arise where the subsidiary is a domestic company which is engaged in the lending or finance business abroad and which except for the exceptions noted below would be subject to the interest equalization tax on its lending activity. In this case also under present law, it could be argued that the subsidiary was "formed or availed of" by the parent company, thus rendering the parent's direct investment in the subsidiary subject to tax. These results could occur regardless of whether the amounts invested in the subsidiary will actually be used outside of the United States or will remain in this country or regardless of whether the amounts invested were obtained from foreign or domestic sources.

Under present law, however, several exceptions are provided to the general rules set forth above.

Investments of any parent company in a domestic or foreign lending or financing company are free of interest equalization tax if satisfactory assurances are given that the invested funds will be used exclusively within the United States or if the funds invested are obtained from foreign sources. This treatment is available in the case of investments in a domestic company which is primarily engaged in the lending or financing business outside of the United States and also in a qualified lending or financing corporation (a QLFC). If a QLFC makes an election under present law, it will be eligible for tax-free direct investment treatment. In addition, if the electing company is a domestic corporation, it will be exempt from the tax on the loans it makes in its financing business.

Tax-free direct investment treatment is to be available for investments by a U.S. company in either a domestic corporation (described in sec. 4920(a)(3)(C)) which is primarily engaged in the lending or financing business outside the United States and which has elected to be treated as a foreign issuer or obligator, and also in the case of investments in a domestic or foreign company which is a QLFC. To obtain this treatment, it must be established to the satisfaction of the Secretary or his delegate, pursuant to regulations which the Treasury Department promulgates, that the amounts invested in the financing subsidiary which are obtained from U.S. sources will not be used to acquire foreign stock or debt obligations or utilized in any other way outside the United States. Thus, the amounts from U.S. sources could not be used for physical plant or equipment located outside of the United States or for working capital purposes outside the United States. Alternatively, if the amounts invested are to be used outside the United States it must be shown to the satisfaction of the Treasury Department that the funds were obtained from foreign sources.

In determining whether funds were obtained from foreign sources, it is contemplated that amounts which are considered repatriated to the United States are not to be treated as foreign source funds. In addition, for this treatment to be available, it also must be established to the satisfaction of the Treasury Department that the information and records with respect to the financing subsidiary in which the investment is made that are necessary to insure compliance with the provisions of the interest equalization tax will be made available to the Treasury Department.

In order for a company to be a QLFC in which a tax-free direct investment may be made (including a domestic company which may elect to be exempt from the tax on the loans it makes in its financing business) a number of conditions must be satisfied.

The first requirement which must be met is that substantially all of the business of the company must consist of specified activities. These activities are—

(1) making loans (including loans made under a lease which is principally a financial lease);

(2) acquiring accounts receivable, notes, or installment obligations if these arise out of the sale of tangible personal property or the performance of services;

(3) the leasing of tangible personal property where financial leasing is not involved (but only if this activity accounts for less than one-half the business of the company);

(4) servicing debt obligations; and

(5) incidential activities carried on in connection with the foregoing types of businesses.

The second requirement which must be met by the financing company in order to qualify under this provision is that the loans made by the financing company to foreign persons must be made with foreign funds (i.e., all the foreign debt obligations acquired by the company must be acquired solely out of funds from specified foreign sources). In addition, the foreign produced or manufactured tangible personal property acquired by the company for use in its regular leasing business must be acquired solely out of funds from the specified foreign sources. The specified foreign sources generally are loans from any foreign person other than a foreign partnership or corporation in which a tax-free investment could be made and certain additional types of foreign funds. One of these additional types of foreign funds is retained earnings and reserves of the company which are attributable to its foreign lending or financing business. Another type of permissable foreign source funds is certain trade accounts and accrued liabilities which are attributable to the company's foreign lending or financing business. A third additional source of foreign funds are funds the financing company receives as a contribution to its capital or as a payment for its stock where the funds were derived from the sale of debt obligations by a related company to the specified types of foreign persons.

Under present law, the foreign funds utilized by the financing company generally must be borrowed either by it, by a domestic corporation (described in sec. 4912(b)(3)) which owns all of the stock of the financing company, or by any domestic corporation (described in sec. 4912(b)(3)) which was an includible corporation in the same affiliated group as the financing company.

The third requirement which must be met by a company to be a QLFC is that the company may not acquire any stock, either foreign or domestic, other than stock of a related company which it acquires as payment for its stock or as a contribution to its capital.

The financing company must satisfactorily identify its stock certificates or debt obligations so they clearly indicate they are subject to the tax if acquired by an American. In addition, the financing company must maintain the necessary records and accounts and submit the necessary reports to establish that it has satisfied the prescribed conditions.

Present law provides that a domestic company may elect to be treated as a QLFC (and a foreign corporation may give notice to the Treasury Department that it is a QLFC) in such manner as is provided in regulations prescribed by the Secretary or his delegate. If a QLFC which has made the election fails to meet any of the prescribed requirements, its election is to be deemed revoked. Generally, if the election is revoked, the financing company, if it is a domestic corporation, is to be subject to tax on all stock or debt obligations which are held by it at the time of the revocation to the extent it would have been liable for tax if it had acquired those stock or debt obligations at that time. If a domestic financing company becomes liable for tax in this manner and this also causes the company, which previously made the tax-free investment in the financing company under this provision, to be liable for the tax on the direct investment, the tax liability of the financing company (as otherwise determined under this provision) is to be reduced by the amount of tax paid by the company making the direct investment.

*Suggestions received by committee.*—

(a) *Percentage of stock ownership by parent corporations.*—With respect to the requirement that a QLFC may only make loans to foreigners out of the proceeds of the payment for its stock or contributions to its capital if derived from the sale to foreigners of securities by a more than 50 percent related corporation, it has been stated that if a 50 percent or less stockholder contributed capital derived from foreign source borrowing to the corporation, the corporation could not loan these funds to foreigners (it could only loan the funds to U.S. persons). Therefore, for example, if two U.S. corporations own 50 percent each of a QLFC, none of the capital they contribute can be used to make loans to foreigners even though the funds were raised abroad. It has been suggested that the more than 50 percent related corporation restriction be reduced to conform to the 10 percent direct investment exclusion. Under this suggestion the corporation would only be restricted in its making loans to foreigners out of foreign funds received by a less than 10 percent shareholder. Furthermore, it has been suggested that the statute be made clear that equity contributions by foreign persons are permissible.

Haskins & Sells for Household Finance Corporation
James W. Riddell for C.I.T. Financial Corporation

(b) *Source of funds of QLFCs.*—As explained above, under present law a QLFC may obtain foreign funds through a borrowing by certain related domestic corporations. These related domestic corporations are financing subsidiaries which are treated as being formed or availed of because of this transaction, for purposes of the IET, and the debt obligations they issue for this purpose are subject to the IET if acquired by U.S. persons.

Under present law, it is possible for a domestic corporation to designate a particular issue of its debt obligations as being subject to the IET so that they may be sold outside the United States. Any acquisition of these debt obligations by a U. S. person is subject to the tax. It has been suggested that a QLFC be allowed to obtain funds from the sale of debt obligations by a related domestic corporation whose debt obligations are subject to the IET.

Shearman & Sterling for First National City Corp.

(c) *Exclusion for acquisitions by QLFCs to finance exports.*—As described above under present law, a QLFC may use its own domestic funds to acquire property manufactured in the United States for leasing outside the United State. However, such a corporation may not use domestic funds to finance export transactions even though other corporations may finance such transactions and not be subject to the IET. For example, domestic funds of such a corporation may not be used to finance the sale of property manufactured in the United States. Further, a parent corporation's investment in a QLFC may not be used to finance the leasing of U.S. manufactured goods for use outside the United States. It has been suggested that a QLFC be permitted to use domestic funds for these activities.

Shearman & Sterling for First National City Corp.

(d) *Equity investments of QLFCs (foreign consolidated returns and foreclosures)*

As described above, under present law QLFCs are generally not permitted to own the shares of other corporations.

(i) For purposes of simplifying and integrating the corporate structure, it has been suggested that a QLFC be able to hold 100 percent of the shares of other QLFCs. Among the reasons such a corporate structure may be created is that it facilitates the filing of consolidated returns in the foreign country in which the parent and subsidiary are organized.

(ii) Alternatively, it is suggested that a QLFC be permitted to acquire interests in partnerships and stock in other QLFCs either wholly or partly owned. However, these investments would only be allowed if, immediately following the transaction, the acquiring corporation owns at least 10 percent of the stock of the acquired corporation. Or, in the case of partnerships, the acquiring corporation owns at least 10 percent of the profit interest in the partnership (in which case the corporation would be considered as directly receiving its proportionate share of the partnership's items of income and as owning its proportionate share of the partnership's assets).

(iii) In addition, it is suggested that QLFCs be able to hold certain other shares which are acquired through foreclosure where such stock was held as security for a loan or a lease, for any period of time desired by the taxpayer.

(i) (iii) Sherman & Sterling for First National City Corp.

(ii) (iii) Paul, Weiss, Rifking, Wharton & Garrison for Armco Steel Corporation

(e) *Equity investments of QLFCs (acquisitions in connection with loans)*

As described above, under present law, QLFCs are generally not permitted to own the shares of nonqualified lending and financing corporations. It has been stated that it is a normal business practice in certain circumstances for a company which makes loans to acquire stock or warrants in connection with a lending transaction. It has been suggested that a QLFC be permitted to acquire stock of foreign issuers incidental to and in connection with a bona fide lending or finance transaction.

James W. Riddell for C.I.T. Financial Corporation

(f) *Equity investments of QLFCs (foreign usury laws)*

As described above, under present law QLFCs are generally not permitted to own the shares in nonqualified lending and financing corporations. It has been suggested that in certain cases a QLFC may purchase the shares of a subsidiary of a foreign corporation at a bargain price and then immediately resell the shares to the subsidiary's parent at a higher price in order to obtain income from the transaction in excess of the interest permitted under the foreign country's usury laws. A QLFC may also be leasing property to a foreign corporation operating in a foreign country which requires that any tax benefits such as accelerated depreciation be passed on to the foreign corporation leasing the property. In such a case, the QLFC may enter into a contract with the parent of the foreign subsidiary which provides for the purchase of the shares of the foreign subsidiary at a bargain price and then immediately permits the resale of the shares to the foreign parent at a price which reflects the lost tax benefits. It has been suggested that these types of equity acquisitions be permitted.

Shearman & Sterling for First National City Corp.

(g) *Foreign source borrowing by QLFCs fom related corporations*

As explained above, under present law if a QLFC borrows foreign source funds from a related foreign corporation, such funds are treated as being from a qualified foreign source (and thus the corporation can continue to qualify as a QLFC). However, such borrowing can only occur where the related foreign corporation has given prior notice of its intent to borrow from non-related foreign sources and to use such funds to lend to the related QLFCs. Furthermore, a QLFC is not permitted to borrow from another QLFC.

It has been suggested that the rules of prior notice and tracing are inappropriate and unnecessary in the case of borrowing by a QLFC from a related foreign commercial bank. Therefore, it has been proposed that such borrowings should be excepted from the prior notice and tracing requirements, and that one QLFC should be allowed to borrow from another such corporation which is related to it.

Shearman & Sterling for First National City Corp.

*15. Proposed exclusion for loans for exploration of natural gas*

*Present law.*—Under present law, if a U.S. person makes a loan to a foreign lease or concession holder to assist in the exploration for, and development of, natural gas deposits on the lease or concession, the acquisition of the debt obligation by the U.S. person is subject to the interest equalization tax.

*Suggestions received by committee.*— It has been suggested that a new exclusion be provided to make the interest equalization tax inapplicable to loans by U.S. persons to a foreign person to be used in the exploration for, or development of, natural gas deposits. However, this new exclusion is to apply only if the U.S. lender, or a related corporation, has the right to purchase a substantial portion of any natural gas which may be produced from the deposits developed in this manner.

Miller & Chevalier for Pacific Lighting Corporation

*16. Corporations formed to acquire foreign securities*

*Present law.*—If a domestic corporation or partnership acquires foreign securities, generally, it is subject to the interest equalization tax on those acquisitions. In addition, if it is found that the corporation or partnership, so formed or availed of for the principal purpose of acquiring foreign securities, the shareholders or partners are taxed on their stock or interest as if it were foreign. In this case, a credit for their taxes is given to the corporation or partnership. It has been stated that if an investment company acquires more than a de minimis amount of foreign investment, the entire issue of the shares of the investment company is subject to the interest equalization tax at the full rate in the hands of the investment company shareholders.

*Suggestions received by committee.*—It has been suggested that the interest equalization tax be imposed at the corporate level, rather than the shareholder level, where all the foreign investments of the domestic corporation were taxable or were exempt from taxation by reason of the exclusions relating to less developed countries, the Canadian exemption, the exemption for prior American ownership and compliance, or as foreign stock treated as domestic. Acquisitions which would be excluded from tax under other provisions, such as the direct investment exclusion, would be taxable under the present rules at the shareholder level with a credit to the corporation.

O'Melveny & Meyers

*17. Variable IET tax rates for different classes*

*Present law.*—Under present law, the President has the power to increase or decrease the rates of tax, and the rates of tax on original or new issues may be lower than the rates on other issues. The original or new issue rate variation may be applicable to all original or new issues or to any aggregate amount or classification. In addition, it may apply to acquisitions occurring during particular periods of time, and may provide for other limitations and implementing procedures.

*Suggestions received by committee.*—It has been suggested that the rate-making power of the President be extended to give the President the authority to determine the tax rate applicable to different countries or different types of securities subject to the provisions of the tax.

John E. Leslie for the New York Stock Exchange Advisory Committee on International Capital Markets

*18. Investment credit for motion picture film*

*Present law.*—Under present law, the investment credit is generally not available for property which is used predominantly outside the United States. It has been stated that it is difficult to determine the useful life of a motion picture film since this involves a forecast of its success.

*Suggestions received by committee.*—It has been stated that the investment credit is generally not available for motion picture films which are often circulated both in the United States and in foreign countries at the same time because of the rule which provides that the investment credit is generally not available for property which is used predominantly outside the United States. It has been suggested that a motion picture film or tape should be eligible for the investment credit, but only in those cases where at least 60 percent of the total amount paid for direct labor costs incurred in the production of the particular picture are paid to American nationals who perform services within the United States. It also has been suggested that an election should be made available under which productions which qualify for the credit would receive two-thirds of the credit without regard to useful life.

Senator John V. Tunney

## C. MAJOR ISSUES DISCUSSED BY THE COMMITTEE DURING THE HEARINGS ON THE IET BILL

*1. Canadian exemption*

From its inception, the interest equalization tax has exempted new Canadian issues in the interest of fostering "international monetary stability." Questions have been raised as to whether the Canadian exemption has fostered "international monetary stability."

Canada has borrowed $4.4 billion in the U.S. market since 1968, while running balance of trade and balance of payments surpluses with the United States during this period of $7.1 billion and $6 billion, respectively.

*2. Foreign exchange speculation*

It is not known to what extent American multi-national companies or banks have contributed to the recent attacks against the American dollar.

As one possible way of dealing with this, the committee might consider a foreign exchange reporting requirement which would oblige all American subsidiaries abroad and branches of American banks abroad to report daily, whenever the President declares that an "international monetary crisis" exists, to the U.S. Treasury on their currency holdings; otherwise they would report quarterly.

Another possibility would be to apply the interest equalization tax in the case of direct investments where the Secretary of the Treasury finds that any corporation or bank is engaged in speculation against the American dollar.