# SUMMARY OF INTEREST EQUALIZATION TAX, HOUSE BILL (H.R. 3577), AND TREASURY PROPOSAL FOR EXTENSION

PREPARED FOR THE USE OF

THE COMMITTEE ON FINANCE

BY

THE STAFF

OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

MARCH 7, 1973

U.S. GOVERNMENT PRINTING OFFICE

91-344 WASHINGTON : 1973 JCS-9-73

2

3

4

5

6

7

## 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 achieves 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.

There are certain exclusions from the tax, the two most important of which are the exclusion for direct investments (where there is a 10 percent or greater interest in the foreign company) where the foreign investment controls of the Commerce Department apply and the exclusion for new Canadian securities.

## HOUSE BILL (H.R. 3577)

Under present law, the interest equalization tax expires as of March 31, 1973. The Treasury Department, when its representatives testified before the House Ways and Means Committee, requested that the application of this tax be extended for 2 years, or until March 31, 1975. The House bill extends the application of this tax for a period of 15 months, or until June 30, 1974.

The House bill also makes three minor modifications in the existing provisions of the tax:

(1) 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 the 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. The House bill provides that in the case of debt where this election has been made and certain other conditions are met, 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.

(2) 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 country and whose stock is substantially owned by U.S. persons or residents of less developed countries. The House bill provides that this exclusion is to no longer apply to the acquisition of stock on debt obligations of less developed country shipping corporations. However, the House bill provides for the continuation of this exclusion generally where transactions involving ships were in an advanced stage of completion prior to the date on which this proposal was made by the Treasury Department to the House Ways and Means Committee, January 30, 1973. The less developed country exemption will generally continue to be applicable to nonshipping corporations which have significant operations within those countries.

(3) 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. 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 this 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.

## TREASURY RECOMMENDATION FOR EXTENSION OF TAX

Under present law, the interest equalization tax expires as of March 31, 1973. It is understood that the Treasury Department may recommend that the tax be extended for 21 months or until December 31, 1974 (rather than for 15 months, or until June 30, 1974, as in the House bill), and endorses the other provisions of the House bill. The Treasury indicates that the tax is an essential part of the U.S. balance-of-payments program.

6

7