TAXATION

INTEREST EQUALIZATION TAX ACT[1]

In a message to Congress on February 10, 1965, President Johnson announced that the balance of payment's deficit had run to an alarming $6 billion annual rate for the last quarter of 1964[2] and that the total deficit for the year was $3 billion.[3] At that time he made far-reaching proposals to halt the steady drain on United States gold reserves caused by foreign governments and central banks which, instead of holding dollars abroad, are converting them into gold at the current rate of $35 to an ounce.[4] Our gold reserves are now placed at about $14.5 billion, the lowest they have been since December, 1938.[5]

One of the President's proposals is the extension of the Interest Equalization Tax Act from December 31, 1965, when it is scheduled to expire, to December 31, 1967.[6] This act taxes American purchases of foreign securities in an effort aimed at curbing long-term capital outflows.[7] The outflow of capital, while returning interest, profits, and principal in the future, registers minus quantities in our immediate balance of payments. The short-term effect is necessarily unfavorable to our deficit position.

The Interest Equalization Tax was first proposed by the late President Kennedy to Congress on July 18, 1963.[8] At that time American purchases of new securities issued by Japan, Canada, and many Western European countries threatened to wipe out marked gains in our attempts to bring our international balance of payments into equilibrium.[9] The sale of new foreign securities (including bonds, debts, and stocks) to United States persons ran to a $1.9 billion annual rate in the first half of 1963, which was three times the total figure for 1962.[10] At the same time the total deficit of the balance of payments on regular transactions,[11] including all regular security dealings, hit an annual rate of $5 billion for the first half of 1963, sharply above the $3.1 and $3.6 billion total deficits on regular transactions for

1 Int. Rev. Code of 1954, §§ 4911-31, as added by the Interest Equalization Tax Act, Pub. L. 88-563, 78 Stat. 809 (1964), (cited below as Int. Rev. Code of 1954).

2 Wall Street Journal, Feb. 11, 1965, p. 3, col. 1.

3 Less than half of this had to be financed by the sale of gold or of dollars since many dollars were held abroad.

4 France has been the biggest converter of dollar credits into gold. See generally, Economist, Feb. 6, 1965, p. 567.

5 Boston Herald, March 20, 1965, p. 19, col. 5.

6 H.R. 4750, referred to House Ways and Means Committee by the President on Feb. 10, 1965.

7 The outflow of private capital last year was $2 billion over 1963, and $2½ billion over 1960. Dept. of State Bulletin, Vol. LII, No. 1341, p. 336, March 8, 1965.

8 109 Cong. Rec. 12806 (1963).

9 See S. Rep. No. 1267, 88th Cong., 2d Sess. (1964) in 14 U.S. Code Cong. & Admin. News 3478, 3482 (1964) (cited below as S. Rep. No. 1267).

10 Id. at 3487.

11 These regular transactions include government transactions, but exclude nonscheduled repayments of government loans, advances from other countries on military exports, and other special measures taken to reduce the financial burden of the deficit such as medium term borrowing. See S. Rep. No. 1267, supra note 9, at 3480, n.2.

1961 and 1962, respectively.[12] Although the purchase of foreign securities represents less than half of the more than $6 billion yearly total of American private investment abroad,[13] the sharp increase in security purchases posed an unexpected threat to our balance of payments at a time when the deficit picture was brightening somewhat.[14]

Without the tax a continued drain on United States capital and, consequently, on United States gold, could have been expected because of several factors. Foremost is the basic economic fact that prevailing interest rates in the United States are lower than in almost all of the industrialized countries of the Free World, thereby providing foreigners with a ready source of relatively low cost capital.[15] Increased savings in the United States has created an abundance of funds for long-term capital investment. Access to these funds is not hampered by governmental restrictions.[16] The demand on United States capital has been compounded by countries with chronic deficits who must borrow heavily in the United States in order to purchase American goods. In addition, many European companies are turning more and more to the United States capital market because they are finding it harder to maintain their planned investments on decreasing retained earnings which have resulted from rising production and labor costs.[17]

Greater profits, growing markets, a relative shortage of profitable domestic investment opportunities and a chance to diversify have lured American investors to send their money abroad.[18]

The Interest Equalization Tax is an excise placed upon the purchase by a United States person of a debt obligation of a foreign obligor, or stock of a foreign issuer.[19] The tax rate on the transfer of stock is 15 percent of the actual value of the stock at the time of transfer.[20] The tax rate on the transfer of debt obligations varies from 15 percent on obligations with a maturity of 28½ years or more, down to 2.75 percent for those with a maturity between 3 and 3½ years.[21]

In order to compete effectively for capital in this country, a foreign issuer would have to reimburse the American purchaser for the amount of

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12 See S. Rep. No. 1267, supra note 9, at 3480.

13 See Statist, Feb. 19, 1965, p. 527, col. 1; Wall Street Journal, March 4, 1965, p. 2, col. 3.

14 See S. Rep. No. 1267, supra note 9, at 3480.

15 Id. at 3485.

16 Certain countries in Europe, viz., Britain, Holland, and Switzerland, although possessing available capital at relatively low rates, protect their payments position by restricting the amount of capital allowed to go abroad. Id. at 3485.

17 Hearings on the Interest Equalization Tax Act before the House Ways and Means Committee, 88th Cong., 1st Sess. 61 (1963).

18 Id. at 62.

19 Int. Rev. Code of 1954, § 4911(a). A "foreign issuer or obligor" includes international organizations of which the United States is not a member, governments of foreign countries and their agents and instrumentalities, corporations, partnerships, estates and trusts not classified as a United States person, and certain domestic corporations electing to be treated as foreign issuer or obligor for the purposes of the chapter. Int. Rev. Code of 1954, § 4920(a)(3).

20 Int. Rev. Code of 1954, § 4911(b)(1).

21 Int. Rev. Code of 1954, § 4911(b)(2).

the tax which is technically assessed to the American purchaser. The rates are designed to raise the cost of American capital to foreign issuers of securities by approximately one percent.[22]

By eliminating the interest rate differential, borrowing would be put on an equal basis whereby market conditions would control decisions to borrow. By reducing the desirability of United States capital, it was hoped that foreign capital markets would be forced to expand in order to finance foreign development, thereby increasing international monetary stability and decreasing the drain on United States capital and gold reserves.

The Interest Equalization Tax was designed as a temporary measure to reduce the balance of payment's deficit until more fundamental factors were able to achieve an equilibrium in the inflow and outflow of goods, services and capital.[23]

The tax exempts obligations with a maturity of less than three years because monetary policies were believed to be adequate to influence short-term rates, as by a manipulation of the discount rate.[24] Other exclusions exempt the purchase of foreign securities when tied to commercial practices, such as export of goods;[25] when tied to the investment needs of underdeveloped countries;[26] when a country's deficits threaten the international monetary stability[27] (Canada); and, when the purchase has no effect on the balance of payments, *e.g.*, an American purchase of a foreign security from another American, or when it does affect the balance of payments, as a purchase necessitated by minimum ownership requirements of foreign countries imposed upon Americans doing business there.[28] Exclusions for direct investments[29] are granted except where the foreign corporation or foreign partnership is formed or availed of by the United States person

[22] The purchaser would likely ask the issuer or obligor to pay a higher interest rate. The tax, all of which would have to be paid at the time of the transaction, is approximately the present value of the increased interest payments spread over the period of the life of the obligation when discounted at about the prevailing rate for foreign securities.

[23] Hearings on Interest Equalization Tax, supra note 17, at 59. These fundamental stabilizing factors are continued cost and price stability, recently threatened by union wage settlements; maximum savings in military expenditures abroad; tying more economic and military aid to United States produced goods; export expansion; restraints on the outflow of short-term capital; broad liberalization of world trade in industrial and agricultural goods; a stable convertible dollar at $35 per ounce of gold; more bilateral and multilateral credit arrangements; solutions to the problem of some countries' chronic deficits; international liquidity to finance world trade, and the raising of incomes in underdeveloped countries. See Economic Report of the President, pp. 13-14 (January, 1965).

[24] See S. Rep. No. 1267, supra note 9, at 3489.

[25] Int. Rev. Code of 1954, § 4914(c).

[26] Int. Rev. Code of 1954, § 4916.

[27] Int. Rev. Code of 1954, § 4917.

[28] Int. Rev. Code of 1954, § 4914(b)(3).

[29] The Senate Report stated that:

> Direct investment implies active participation in the management of the foreign corporation. Decisions to make investments of this type largely are concerned with questions of market position and long-range profitability rather than interest-rate differentials.

S. Rep. No. 1267, supra note 9, at 3492.

for the principal purpose of acquiring foreign securities through such corporation or partnership, if the direct acquisition of the security by the United States person would be subject to the tax imposed by section 4911.[30] In other words, United States persons are not allowed to form "closely held" holding companies for the purpose of acquiring securities which would be taxed if directly acquired.

New York securities dealers, foreign companies and some foreign governments stood opposed to the enactment of the bill. Charges of governmental control were anticipated, for President Kennedy stated in his special balance of payments speech that "this nation will continue to adhere to its historic advocacy of freer trade and capital movements."[31] Whether viewed as direct control on private capital or not, the tax appears to discriminate against the smaller investors, for direct investment by corporations in subsidiaries abroad or by a person having a 10 percent share in the control of a foreign company is not taxed under the act.[32]

In defending the proposed tax, Secretary of the Treasury Dillon, emphasized that it was the speculative foreign issuer who was being singled out and diverted from United States capital markets. He said:

> The higher borrowing rate for foreigners resulting from the tax will not be prohibitive and long term funds will remain available to those prepared to meet the normal market test of willingness to pay the prevailing rate. Those who have urgent needs for longer term funds not available on reasonable terms elsewhere will continue to make use of our unrivalled facilities; those who today merely find their own or other markets marginally too costly for their taste will be diverted from our markets.[33]

Indeed, many times loans were not connected with exchange needs or related to import requirements from the United States, but were designed to finance construction projects with small import content, or to support internal budgetary deficits of central governments; and, finally, some dollar bond issues went to purchase already existent domestic facilities. The dominant motivation has been the lower rate of interest.[34]

There was some basic disagreement with the premise that the tax would remedy the causes of the balance of payment's deficit. Rep. Thomas B. Curtis said:

> This outflow results from an unfavorable investment climate in this country arising from a weakness in business confidence based upon the continuing profits squeeze, chronic Federal budget deficits and the slow but steady erosion of the value of the dollar. . .[35]

[30] Int. Rev. Code of 1954, § 4915(c)(1).

[31] Hearings on Interest Equalization Tax, supra note 17, at 3.

[32] Int. Rev. Code of 1954, § 4915.

[33] Hearings on Interest Equalization Tax, supra note 17, at 65.

[34] Id. at 61. Bank loans over one year maturity increased by $1 billion in 1964. The bulk went to industrialized countries with only 15 percent serving to finance United States exports.

[35] Hearings on Interest Equalization Tax, supra note 17, at 105.

It was urged that if purchases of foreign securities were to be taxed, the larger portion of capital outflows represented by direct investments by corporations abroad should also be taxed.

Several alternatives to the Interest Equalization Tax were proposed, one of them being a capital issues committee. This was backed by the *New York Times,* Senator Jacob Javits, and New York brokers. The *Times* stated:

> We continue to believe that a capital issues committee operated by the Treasury and Federal Reserve would be a more efficient and effective instrument of control. It would mean that Washington and not foreign borrowers would have responsibility for the size of the flow. It could be used also to regulate direct investment by American corporations, which accounts for a large part of the outflow, but is not affected by the proposed tax.[36]

The Administration rejected this proposal as offering too much control over the free flow of trade and capital.[37] Recent developments, however, indicate a shift to a policy of more control.

Another alternative proposed was an increase in the interest rates on long-term loans. The Administration's easy money policy for domestic borrowers dictated against this move, however.[38] If the long-term interest rates were to be raised through the monetary policies of the Federal Reserve Board, money would become scarce, not only for foreign, but for American investors, at a time when investment is below what it should be and when domestic unemployment remains high.[39]

While new issues of foreign securities produced an adjusted drain of $585 million in the 4th quarter above $161 million in the 3rd quarter, the Interest Equalization Tax has had some effect, *e.g.*, the sales volume of foreign corporate securities in New York was $560 million in 1962, $718 million in 1963, and down to $434 million in 1964.[40] Because the act was retroactive its greatest effect was during the period from its proposal, July 18, 1963, to its final signing, September 2, 1964. Overall, however, the purchase of foreign securities remains $500 million above the 1960 level.[41]

One provision of the act which detracted from its effectiveness was the exemption granted "debt obligations of commercial banks in making loans in the ordinary course of its commercial banking business."[42] The exemption applied to all such loans, including those with more than a three-year maturity. This exemption was granted in part because most commercial bank loans have less than a three-year maturity and would not, therefore, be subject to the tax in any event.[43] A more cogent reason for the exemption was

36 See Hearings on Interest Equalization Tax, supra note 17, at 223.
37 Id. at 8.
38 Ibid.
39 Id. at 63.
40 See Statist, Feb. 19, 1965, p. 527, col. 1.
41 Dept. of State Bulletin, Vol. LII, No. 1340, p. 284, March 1, 1965.
42 Int. Rev. Code of 1954, § 4914(b)(2).
43 See S. Rep. No. 1267, supra note 9, at 3493.

the recognition "of the special role played by banks in support of normal, recurring financing of the international business of American firms."[44] The exemption granted commercial banks in the context of the restrictions on non-bank credit resulted in a sharp upsurge in the outflow of capital from commercial banks. The outflow of short-term bank loans bounded to a seasonally adjusted $441 million in the 4th quarter of 1964, after the tax was passed, from $172 million in the 3rd quarter.[45] At the same time long-term bank loans rose to $331 million from $246 million in the 3rd quarter.[46]

In light of the increase in commercial bank loans abroad, the President, on February 10, 1965, invoked the standby authority vested in him by section 4931 of the act,[47] determining

> that the acquisition of debt obligations of foreign obligors by commercial banks in making loans in ordinary course of the commercial banking business has materially impaired the effectiveness of the tax imposed by section 4911, because such acquisitions have, directly or indirectly, replaced acquisitions by United States persons, other than commercial banks, of debt obligations of foreign obligors which are subject to the tax imposed by such section.[48]

Section 4931, made effective by the President's Order, withdraws the exemption from the tax which had been given to commercial banks. In addition, commercial bank loans with a maturity of over one year and less than three years are made subject to a special schedule of taxes.[49] The President has further asked for legislation extending the coverage of the act to non-bank credit of one to three year maturity.[50] Since commercial banks are now subject to taxation on credits of less than three year maturity, legislation was thought appropriate to avoid discrimination against banks, inviting "an outflow of untaxed funds through non banking channels."[51]

The President is given authority under the Interest Equalization Tax to exempt any country's securities when the imposition of the tax would have "such consequences for a foreign country as to imperil or threaten to imperil the stability of the international monetary system."[52] It was originally thought that only Canada's new securities would be exempted under this provision.[53] However, because of the great hardship the tax worked upon Japanese security issuers, the President has recommended that a $100 million yearly exemption also be given to securities issued, or guaranteed, by the Japanese Government.[54]

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[44] Ibid.

[45] See Wall Street Journal, supra note 2, col. 5.

[46] Id. at cols. 5-6.

[47] Int. Rev. Code of 1954, § 4931.

[48] Exec. Order No. 11198, 30 Fed. Reg. 1929 (1965), citing Int. Rev. Code of 1954, § 4931.

[49] Int. Rev. Code of 1954, § 4931(c).

[50] 111 Cong. Rec. 2419 (1965).

[51] Ibid.

[52] Int. Rev. Code of 1954, § 4917.

[53] See S. Rep. No. 1267, supra note 9, at 3491. Int. Rev. Code of 1954, § 4917 was invoked by Exec. Order No. 11175, 29 Fed. Reg. 12605 (1964).

[54] Wall Street Journal, Feb. 11, 1965, p. 3, col. 1.

The President has made it clear that the Administration does not intend to rely solely upon the Interest Equalization Tax to restrain the outflow of United States capital to industrialized countries. He has called for "voluntary restraint" on direct, private investment abroad by some five-hundred United States corporations having overseas operations.[55] Regardless of their size, and whether their individual balances of payments are plus or minus, corporations have been asked to reduce their direct foreign investments by from 15 to 20 percent and repatriate as much of their liquid funds abroad as possible.[56] The giant corporations with subsidiaries who have adequate retained earnings from their foreign sales will be able to cut back on the amount of capital sent abroad. At the same time their investment programs overseas can continue at a steady pace, financed out of these retained earnings. Smaller firms will find compliance more difficult since their foreign sales cannot always provide them with sufficient profits for expansion. They must rely upon the United States capital market to finance their foreign operations. Firms just now expanding abroad will be especially hard hit so long as no exception is made for them under the "voluntary restraint" program.

In line with the Administration's policy on cutting back the outflow of United States capital, the Federal Reserve is overseeing a program to enlist the nine major banks dealing in foreign loans to restrict their outstanding credits in 1965 to a mere 5 percent increase above the $10 billion total outstanding credits for 1964. In other words these banks are expected to cut back their loans from $2.3 billion last year to $500 million this year.[57]

Legislation may be forthcoming that would suspend anti-trust laws as they might apply to a joint decision by big banks to refuse a credit application by a foreign interest which, with respect to the Administration's present policy, would not appear to be in the national interest.[58] Many foreign loans must be jointly financed by United States banks, so that a suspension of anti-trust prosecutions would enable the banks to meet, together with a Treasury representative, and determine which loans, whether taxable under the Interest Equalization Tax or not, would promote the national interest.[59]

The United States is in the unenviable position of trying to maintain an equilibrium in its balance of payments in order to stop a steady drain on its gold supply, and, at the same time, encourage freer and increased trade among the nations of the world. These two policies have been criticized as being basically inconsistent. The *Economist* commented thereon:

> The fact remains that there is a profound contradiction between the labors of the American negotiators in Geneva for freeing trade in the Kennedy round of tariff reductions and the equally fervent

[55] Id. at col. 2.

[56] Id. at col. 3. Two billion dollars of American money is held abroad in time deposits and liquid securities to earn a slight interest advantage. For every million dollar drain on United States balance of payments, the President estimates that only $2,500 is earned yearly by keeping funds abroad. See Dept. of State Bulletin, Vol. LII, No. 1341, pp. 336-37, March 8, 1965.

[57] Wall Street Journal, March 4, 1965, p. 2, col. 3.

[58] Ibid.

[59] Id. at col. 2.

> labors of the Commerce Department and the Federal Reserve Board for restricting exports of capital and invisible foreign transactions through the voluntary balance of payments program.[60]

Looking toward the foreseeable future, a London bank has expressed grave doubts as to the advisability of the United States' attempt at balancing its international payments. It stated that:

> Undoubtedly, the great expansion of world trade since the war has been very largely aided by the continuous outflow of dollars from the United States and, if the United States succeeded in its declared aim of balancing its international payments, the other countries of the world would certainly find the creditor positions which they have been enjoying rapidly altered. Already there is a general tendency in Europe for money rates to rise and there is a danger that, if each country tries to defend its currency reserves by increasing rates and restricting credit, a general depression may supervene.[61]

Yet, the United States must control its balance of payments in order to bolster foreign confidence in the dollar as a reserve currency, to reduce the likelihood of a shift away from the dollar, and to avoid the possibility of a run on the dollar.

The government has attacked the outflow of capital through the various measures discussed above, and it seems quite likely that the government's concern and direct participation in this area will remain for some time. The Interest Equalization Tax, originally only a temporary measure, is taking on a look of permanence. The same may be true of the restrictions on bank loans abroad. It does not seem possible, however, to restrain corporations from investing as much as they would like in order to compete for the opening markets of the world, for an extended period of years. Having begun direct controls on capital flows abroad, more of such governmental activity can be expected. The remaining question is whether, once an equilibrium in the balance of payments is achieved, the government will be able to withdraw and leave the capital and investment market as free of direct controls as it was before the Interest Equalization Tax and ensuing measures.

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60 Economist, Feb. 27, 1965, p. 888, col. 1.

61 Economist, Feb. 6, 1965, p. 601, cols. 2-3.