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THE UNITED STATES INTEREST EQUALIZATION TAX

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The Interest Equalization Tax (IET), originally enacted in 1964 as a "temporary" measure by the Congress of the United States to reduce the balance of payments deficit was extended in late September of 1969 for the sixth time. The new extension will be in effect until March 31, 1971. For each extension Congress set forth the same reasoning — the IET has favorably contributed to the U.S. balance of payments position by causing a reduction in foreign securities purchased by United States persons, but due to the deficit in our balance of payments and the increased amount of borrowing in the United States by foreigners that *would* occur if the tax were allowed to expire, an extension is desirable.

Based on the rationale set forth above, it appears that the IET is here to stay, at least for the foreseeable future. Due to the extreme importance of this tax upon foreign investments a discussion of its provisions appear indicated.

The IET was enacted originally on September 2, 1964 by Public Law 88-563 which in effect added sections 4911-4920 and 4931 to the Internal Revenue Code of 1954. (All references to sections herein shall be to this Code.) In general the tax is imposed on each acquisition by a United States person of stock of a foreign issuer or of a debt obligation of a foreign obligor made after July 18, 1963. The amount of tax was *originally* set up to be 15 percent of the actual value of the stock acquired and for debt obligations the amount of tax was to be determined by a sliding scale with the amount dependent upon the number of years remaining until maturity with a low of 1.05 percent for those obligations with a maturity of one to one and one-quarter years and a high of 22.5 percent for those obligations with a maturity of 28 and one-half years or more.

Since the principal idea of the IET is to aid in keeping the balance of payments in line, the tax provides for future modifications of the tax rates by executive order. (Section 4911(b)(2)) Acting under this

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authority, President Nixon by Executive Order No. 11464 dated April 3, 1969, adjusted the rates to what is now their present level. The present rate for stock acquisitions is a flat 11.25 percent, while the rates for acquisition of debt obligations range from 0.79 percent to 11.25 percent as determined by the period remaining to maturity. The Interest Equalization Tax Extension Act of 1969 changed this executive modification provision to give the President, at his discretion, the power to modify the tax rates to prescribe a lower rate of tax for new issues of foreign stock than the rate applicable to outstanding issues of foreign stock. Previously the rate for the new and outstanding issues had to be the same.

The type of financial drain on the United States which the IET was enacted to prevent was the drain occurring when foreigners seek United States long-term capital for the sole reason of the lower interest rate. Many investments do not fall into that category and are thereby granted exemption from the tax. These exemptions are based upon reasons of sound business decisions and American foreign policy. For this discussion the exemptions will be divided into the following categories:

1. Exclusion for Direct Investment;
2. Investments in Less Developed Countries;
3. Transactions not Considered Acquisitions;
4. Exclusion for Monetary Stability; and
5. Additional Excluded Acquisitions.

EXCLUSION FOR DIRECT INVESTMENT SECTION 4915

The tax imposed by the IET shall not be applicable in situations where immediately after the acquisition:

(1) the United States person owns ten percent or more of the voting power of all classes of stock of the foreign corporation; or

(2) in the case of a foreign partnership, the United States person owns ten percent or more of the profits of the partnership.

If the required percentage of ownership is not met upon the initial acquisition the investor will still be eligible for the exclusion and may apply for a refund of taxes paid if within twelve months after the initial acquisition, he obtains the required ten percent.

In many countries the Government has placed restrictions on the percentage of ownership or profits which may be acquired by United

States investors. This percentage could be less than ten percent. In such a situation the Internal Revenue Code has made special provisions for the United States investor to still qualify for the direct investment exemption. To qualify the investor must acquire at least five percent of the total combined voting power in the case of a corporation (for a partnership he must acquire five percent interest in the profits) and the acquired foreign trade or business must be directly related to the business actively conducted by the United States investor in at least one other foreign country.

Since the above exemptions could very easily be used to circumvent the provisions of the IET, the Code has provided a number of instances where the exemption will be disallowed. If the United States person forms or uses the foreign corporation or partnership for the principal purpose of tax avoidance or to acquire through such corporation or partnership interests whose direct acquisition would be subject to the IET, the exemption shall be inapplicable. Likewise if the acquisition is made with the intent to sell to any United States person the exemption would be defeated.

The reason for this exemption is that the IET was designed solely to discourage the portfolio investor who is "playing" the foreign market in the attempt to gain higher returns, but the tax was not designed to adversely affect the direct investor who is operating the foreign business. In this case the policy decisions of market position and long-range profits are closely connected with the decision to undertake a direct investment and this planning outweighs the reasons for the IET.

INVESTMENTS IN LESS DEVELOPED COUNTRIES SECTION 4916

The IET shall also not apply to the acquisition of:

1. Debt obligations issued by a less developed country;
2. Stock or debt obligation of a less developed country corporation;
3. Acquisition of debt obligations issued by an individual or partnership resident in a less developed country in return for money or other property used wholly within one or more less developed countries; or
4. Certain stock or debt obligations which were required to be acquired by the United States person in exchange for having his property expropriated by the government of such less developed country.

For the purpose of this exemption a *less developed country* is a country that is designated such by Executive Order of the President of the United States. Once a country is so designated as being economically less developed for the purpose of the IET, the President may not terminate such designation without first informing Congress of his intent to do so. For purpose of this section Executive Order 11285, published June 11, 1966, is in effect and will be so until there is a subsequent Executive Order issued. This order provides that all countries in the Americas with the exception of the United States and Canada shall fall into this exception.

Acquisition by a United States person of the stock or debt obligations of a *less developed country corporation* shall also be exempt from the provisions of the IET. For the purpose of this exemption a less developed country corporation is a foreign corporation which meets one of three requirements for a specified period of time.

1. A foreign corporation which is engaged in the active conduct of a trade or business having at least 80 percent of its gross income derived from sources within less developed countries and having at least 80 percent in value of its assets consisting of: property used and located in less developed countries; money and deposits anywhere; stocks and obligations of other less developed country corporations; and obligations of and investments required by less developed countries is a less developed country corporation.

2. A foreign shipping company may be a less developed country corporation if 80 percent of its gross income is derived from the using in foreign countries of aircraft and vessels which are registered under the laws of a less developed country and dividends and interest received from foreign corporations which are less developed country corporations. Also at least 80 percent of each class of stock of the corporation must be held on each day by United States persons or residents of less developed countries.

3. A foreign corporation which has at least 80 percent of its gross income, if any, derived from sources within less developed countries or from United States bank deposits or both, and has assets 80 percent or more in value of which consists of: stock or debt obligations of any less developed country corporation or of a less developed country; investments required because of restrictions imposed by such a country; debt obligations of an individual or partnership resident in a less developed country acquisition of which by a United States person would be tax-free; and obligations of the United States, is also considered a less developed country corporation.

In order to fall within one of the above exemptions, the foreign corporation must meet the required tests for three accounting periods:

(1) the annual accounting period (if any) immediately preceeding the accounting period in which the acquisition is made;

(2) the annual accounting period in which the acquisition is made; and

(3) the next succeeding annual accounting period after the acquisition is made.

Through the use of the words "if any" for the immediately preceeding accounting period the Code clears the way for a new foreign corporation to be a less developed country corporation. As the Code does not provide for any exceptions to the second and third periods, all foreign corporations must meet those periods.

Even if a foreign corporation meets the above requirements, it will not automatically be treated as a less developed country corporation. Before the acquisition occurs, the foreign corporation must make application to the Secretary of the Treasury and prove to the satisfaction of the Secretary that it meets the above 80 percent tests and may reasonably be expected to satisfy the annual accounting period requirements. If such a ruling is secured and is favorable, the foreign corporation will have satisfied the less developed country definition and the tax will not be payable with respect to acquisitions made prior to revocation or expiration of the ruling; such favorable rulings are published by the Internal Revenue Service and any investor can take advantage of them.

Even if such ruling is not obtained the exclusion will still be available so long as the foreign corporation has met the 80 percent requirements for the preceeding accounting period (if any) and the acquirer reasonably believes the issuer will satisfy such requirements for the current and next succeeding period. But, in the case where there has been no ruling, if the corporation fails to satisfy the requirements for the current or next succeeding accounting period a liability for the tax will be incurred and the acquiring person is obligated to pay the due tax.

TRANSACTIONS NOT CONSIDERED ACQUISITIONS SECTIONS 4914, 4918

The IET is designed to apply whenever a United States person acquires ownership of stock or debt obligations of a foreign issuer or obligor from a foreign person. Therefore a transfer which is not considered to represent a real change of ownership or a transfer in which stock or debt obligations are acquired from a United States person will not be subject to the tax.

Transfers not considered to be a real change of ownership are: transfers between a person and his nominee, custodian or agent; from a decedent to his executor or administrator; to a survivor upon the death of a joint tenant; from a minor to his guardian; gifts of stock and debt obligations to a United States person who is an individual; generally acquisitions resulting from the corporate distributions and reorganizations; and receipt of a stock option or similar right when received by reason of employment with a foreign corporation are exempt from the tax.

An acquisition by one United States person from another United States person will not be subject to the tax if it can be established that the person from whom the stock or debt obligation was acquired was a United States person throughout the period of his ownership or continuously since July 18, 1963, and had paid the IET on his acquisition or had acquired such without liability for payment of the tax.

EXCLUSION FOR MONETARY STABILITY

This exemption provides that if the President of the United States shall find that the imposition of the IET upon new securities of, or securities originating in, a foreign country would imperil the stability of the international monetary system, he may by Executive Order exempt such securities from the tax. On five occasions this has been done twice involving securities of Canada and three times involving securities of Japan.

In 1963, the President, by Executive Order 11175, exempted from the tax the acquisition of new Canadian stock and debt obligations. This was later amended by the President so as to remove from the exemption stock or debt obligations of a Canadian corporation, partnership or trust formed or used for the principal purpose of acquiring stock or debt obligations of foreign issuers or obligors not themselves qualified for the less developed country or international monetary stability exclusion (Executive Order 11305).

In 1965, the President excluded from the tax the purchases by United States residents of new securities issued or guaranteed by the government of Japan up to an amount of one hundred million dollars per year.

In 1967 this exclusion was extended to new Japanese corporate obligations but did not include the type of security debt disallowed in the executive order applicable to Canada.

President Nixon on February 2, 1970, issued Executive Order 11506 which repealed both of the above Japanese exemptions. The result is that no acquisition of a Japanese debt obligation after February 2, 1970, will be exempt.

ADDITIONAL EXCLUDED ACQUISITIONS SECTION 4914

Other quite complex exclusions of limited use in specified fields are also afforded by the Code. These exclusions are of importance to: persons involved in export credit transactions; insurance companies doing business in foreign countries; certain tax-exempt labor, fraternal and similar organizations having foreign branches or chapters; persons making loans to assure raw material sources; persons acquiring debt obligations on sale or liquidation of wholly owned foreign subsidiaries or sales of foreign branches; and United States persons resident abroad acquiring stock of certain foreign issuers investing exclusively in United States property. As can be readily seen these exclusions refer to particular problems and if a party is engaged in one of the above named transactions he should make a detailed study to see if the exemption is applicable.

Other minor exemptions are of a more general nature and can be dealt with summarily:

1. Acquisitions required under foreign law are excluded from the tax of a United States person "doing business" in a foreign country to the extent that such acquisitions are reasonably necessary to satisfy minimum requirements of that country.

2. Acquisitions made by a United States person "doing business" in a foreign country in accordance with the law of that country as a substitute for payment of tax to that country.

3. Acquisitions from a foreign corporation stock in cooperative housing; and such stock entitles the holder, by reason of his ownership, to live in the co-op.

4. Student loans which do not exceed $2500 to foreigners who are full time students at American educational institutions.

5. Debt obligations acquired by Americans in connection with the

sale of real property located outside the United States which they held before July 18, 1963.

6. Stock or debt obligations acquired by a foreigner during the first 90 days of residing in the United States. These securities will only be subject to tax if subsequently sold to an American.

SPECIAL RULES TO LIMIT THE TAX SECTION 4913

Where stock or debt obligations are acquired as a result of surrender of a different debt obligation, extension or renewal of the obligation by the holder, exercise of option or right to acquire stock or debt obligations, or the converting of debt obligations into stock, a special rule applies for the computation of the tax. The tax in these cases is equivalent to the regular imposed tax reduced by the tax which would have been imposed if the debt obligation which was surrendered, extended or renewed, or the option or right which was exercised, had been acquired in a transaction subject to such tax immediately before such action. If the convertible debt obligation can be converted into stock only within the period of five years or less, the debt was taxed as a stock initially so the exercise of the right will result in no tax.

COMMERCIAL BANK LOANS SECTION 4931

The IET as originally enacted specifically excluded the acquisition of debt obligations of foreign obligors made by commercial banks in the ordinary course of business, but authorized the President of the United States to extend the tax to the banks if he should determine that the acquisition of foreign obligations by commercial banks materially impaired the effectiveness of the IET. As it turned out this exclusion did affect the IET since bank loans were being directly or indirectly substituted for debt obligations of foreigners which were already subject to the IET, or would be subject to the tax. As a result, on February 10, 1965, the President issued an Executive Order extending the IET to most bank loans except export-connected loans.

It is evident from the above discussion that the IET is overburdened with exceptions and exemptions. One indication that there appear to be enough exemptions to please everyone is the fact that to date only one case involving the IET has been decided by the courts, i.e., *Mora* v.

United States, decided in 1966 by the United States District Court for the Eastern District of Virginia. In this case the taxpayer purchased English stocks using funds obtained from the sale of other English stocks which the taxpayer had purchased before the effective date of the act. The Court held that in spite of the President's speeches describing the tax as a measure designed to curb the outflow of gold from the United States, the taxpayers were required to pay the tax even though their transaction did not result in the outflow of gold. Additionally, the court held the IET to be constitutional as being within the power of Congress to levy taxes under Article 1, Section 8, Clause 1 of the Constitution of the United States.

Even with these exceptions and the lack of cases challenging the IET, the Treasury states that the IET has aided in accomplishing its goal, i.e., the U.S. balance of payments position has been improved. In the discussion of the Interest Equalization Act of 1969, the Congress stated:

> The Interest Equalization Tax was first made effective in the middle of 1963 and used in conjunction with the limitations on extensions of credit and direct balance of payments problem. Measured on a liquidity basis, the deficit fell from an average of 2.5 billion dollars in the years 1961 through 1964 to 1.3 billion dollars for 1965 and 1966. In 1967 the deficit increased to 3.5 billion dollars and in 1968 a surplus of 93 million dollars was recorded.