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ASSISTANT SECRETARY

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MAY 25 1962
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E. G. Setser

TO : G - Mr. Johnson
THROUGH : S/S
FROM : E - G. Griffith Johnson
SUBJECT : The Proposed Tax Legislation.

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The following information and comment regarding the proposed tax legislation is supplemental to my memorandum of May 18.

The proposal to abolish the tax deferral privilege for foreign subsidiaries of American corporations is probably the most significant part of the contemplated legislation as far as possible impact upon U.S. interests abroad is concerned. Under present law, undistributed earnings of American controlled foreign corporations are not subject to U.S. tax. The tax is deferred until the earnings are distributed as dividends, and then the tax liability is upon the shareholder.

The Treasury Department is convinced that tax deferral has given artificial encouragement to foreign investment and has deterred the repatriation of foreign earnings, thus contributing to the balance-of-payments deficit. This aspect of the matter has been greatly aggravated, in the Treasury view, by tax-haven operations, in which income of the U.S. corporations and their foreign subsidiaries is attributed to subsidiaries set up in countries with low income tax rates, such as Switzerland.

The Administration has recommended that tax deferral for controlled corporations operating in economically advanced countries be eliminated entirely. This would be done by assessing tax on a pro rata basis against the shareholders of the controlled corporation just as though the earnings had been distributed as dividends. It would continue to allow deferral for subsidiaries established in less developed countries, except subsidiaries clearly engaged in tax-haven operations.

The Ways and Means Committee accepted only in part the Treasury position on tax deferral. The bill it reported, which was approved by the House, contains a very complicated section on the subject. Its general effect, however, would be to tax to the shareholders the controlled corporation's income except the part reinvested in the required activities of the trade or business or reinvested in a less developed country. A large part of the provisions of the section are designed to assure that deferral privileges are not usually extended to income derived from passive investments or from tax-haven operations, while

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allowing freedom for the enterprise to plow back sufficient earnings to maintain its competitive status.

The Department of State has an important interest in the tax legislation from several points of view. Effective measures to reduce the balance-of-payments deficit are very important from the standpoint of our foreign policies. The relationship of taxation to our policies for encouraging investment in the less developed countries has always been regarded as a significant factor. We should be very much concerned, also, if the proposed new tax policies should so antagonize the business community as to stimulate opposition to other essential pieces of legislation, such as the Trade Expansion Act or the foreign aid legislation.

The Department has not up to the present, however, attempted to intervene with respect to any basic provisions of the proposed legislation, although it has been pressed to do so by private interests in a number of instances. The main features of the proposed legislation, including the elimination of deferral, were specifically recommended by the President in his tax message to Congress. The Department has joined with Treasury in seeking the elimination of a provision in the House bill that would interfere with the application of the existing treaties for the avoidance of double taxation. It has also referred to the Treasury for action (with successful results) protests of certain foreign governments against provisions of the bill that would require Americans serving as directors or officers of any foreign corporation to submit to the Treasury such information as it might require regarding the foreign corporation. Adverse criticism of the proposed legislation has generally been referred to the Treasury without recommendation or suggestion.

The elements of the business community involved in foreign investment contend that the Administration tax policy, if enacted into law, will seriously injure American business interests abroad. It is emphasized that other countries do not tax foreign earnings of their corporations, and that the competitive position of the U.S. enterprises will be seriously affected. Some of them take the view that because they have established their businesses under the tax deferral regime, it would be inequitable to deprive them of the privilege now. It is also argued that the special risks accompanying foreign operations entitle enterprises operating abroad to special tax advantages.

The Treasury Department has answered these arguments by asserting that taxation of the undistributed earnings will not make foreign investment generally unprofitable, although it may slow expansion somewhat; that the Finance Ministers of several European governments have advised the U.S. to discontinue tax incentives to investment in Europe in order to check the growth of the balance-of-payments deficit; that the policy of encouraging investment in both developed and underdeveloped countries, which was in the public interest in the early postwar period, is no longer necessary, and preferential tax treatment merely for private gain is not justifiable.

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