Form F.R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

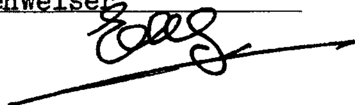
Office Correspondence

Date February 13, 1937

To Chairman Eccles

Subject:

From Mr. Goldenweiser



I transmit herewith three memoranda by Mr. Bryan: one outlining the proposed tax measures for control of capital movements, together with the reasons for the proposals, with some discussion of the enforcement problem. A second special memorandum on the nominee system, and a third one giving the general background and reasons for undertaking some action at this time.

There is also attached a memorandum on this last subject prepared by Mr. Gardner, which I did not expect at this time, and which covers the same subject as Mr. Bryan's last memorandum in somewhat different language and with some additional statistical evidence.

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Office Correspondence

Date February 13, 1937

To

Subject:

From

Dear Mr. Chairman:

Since the conference in your office the other afternoon, I have again had the opportunity of discussing various tax proposals with Mr. Eldon King, Special Deputy Commissioner of the Bureau of Internal Revenue. He has been, as you know, acting as enforcement adviser for the Treasury on the joint technical committee that has been working with the capital inflow problem.

He professes himself as now impressed with the desirability and advisability of a capital gains tax, and he has authorized me, both in personal conversation and by telephone, to inform you of his position in this matter. His present opinion arises from a belief in the possibility of a somewhat simplified administration for a capital gains tax on foreigners in case, as I have suggested, the tax is made a lien against the stock certificate itself and transfers of non-tax-paid certificates are blocked at American transfer offices. This proposal omits, in accordance with your views, all effort to assess capital gains on bonds, and thus largely eliminates the many administrative problems in connection with bearer certificates.

Malcolm H. Bryan

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Office Correspondence

Date February 13, 1937

To Chairman Eccles

From Malcolm H. Bryan
M H B LBC Eccles

Subject: Notes on the Capital Inflow Problem

I. There are two important kinds of income that foreign owners may derive from American security holdings: (1) recurrent yield from interest and dividends, and (2) capital gains.

A. In order to deter the inflow of income-purpose capital, the present tax of 10 per cent on income going to foreign owners should be increased.

Comment:

(1) The tax on yield is necessary to repel the inflow of foreign capital of a permanent or semi-permanent income-purpose character, which would not be dealt with effectively by a capital gains tax or transactions tax.

(2) The effectiveness of this tax will be seriously diminished by a treaty giving Canada a lower rate. Capital will simply flow into the United States through Canada.

B. In order to deter the inflow of speculative capital, a tax of 10-25 per cent is proposed on future capital gains from equity securities, either when such gains result from new security purchases by foreigners or, in the case of securities now held, the accrual of gains from the present value of the security to some future selling price.

Comment:

(1) The tax on capital gains is proposed because in its absence foreigners would be left free to direct their American investment operations solely toward prospective capital gains. The point is

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important because the bulk of foreign holdings of American securities is in common stocks.

(2) The tax on capital gains will be especially necessary in case a treaty discrimination in favor of Canada is made with respect to yield taxes. While the writer has not examined the text of the tentative treaty with Canada, it is presumed that the agreement covers only yield taxes, since our present tax system on foreign holdings does not, except in the case of resident foreign individuals and businesses, involve the taxation of capital gains.

(3) The tax is proposed only on equity securities because: (a) capital gains on bonds are normally of minor importance, and (b) the fact that stock certificates are seldom, if ever, in bearer form would lessen substantially the administrative burden involved in the taxation of capital gains. It appears that stock certificates could be caught at American transfer offices with considerable success.

(4) Capital gains taxes have been proposed only on future gains because there is no apparent method of enforcing a tax on past capital gains. It seems than an attempt to tax accrued gains would simply result in market convulsions as foreigners withdrew funds between the time a proposed law was introduced in Congress and its effective date after passage.

(5) The capital gains tax is suggested, as is true of the other taxes in this memorandum, at a flat rate because : (a) progressive taxes

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can only be justified with reference to a taxpayer's total income, which cannot be known or assessed by the United States in the case of foreigners; (b) progressive rates would create a substantial incentive for the breaking up of large foreign accounts into several smaller ones, and against this practice the United States could exercise little or no administrative self-protection; (c) flat rates permit the payment of the taxes without reference to any arbitrary income period, such as a year; and (d) since taxation at a flat rate does not depend on or vary with the amount of the foreigner's total income, the tax could be made a lien (as is the case in property taxes) against the security certificate itself, which would greatly increase the possibility of adequate enforcement.[1/]

(6) The proposal to tax capital gains involves, as it stands, the taxation of gains from each transaction. Any rate adopted under such a plan, therefore, would be more severe than it appears because an offset of losses would not be permitted. The probable effect would be to discourage a <u>considerable amount of foreign in-and-out trading</u> in our markets, which should be all to the good. The foreign operator who expected to take many losses but to secure a profit on balance would find his opportunity of profit impaired.

(7) Foreigners who took American security certificates abroad and traded in American securities on foreign exchanges should be given the option of paying the capital gains tax on each transaction. In any

1/ This would be similar to our procedure in the enforcement of customs duties, and it is quite important in the event our administrative machinery is not to be elaborate.

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event, only a moderate increase in trading on foreign exchanges in American securities is to be expected from this tax. The fact that the tax would be a liability against the security certificate itself and the fact that each security certificate, having been purchased at a different price, would have against it a different accrued capital gains tax, would seriously impede the freedom with which transactions in American securities on foreign exchanges could be accomplished. The tendency to move transactions into foreign markets would thus be substantially reduced if not eliminated.

II. Enforcement.

The enforcement of taxes on foreigners is necessarily difficult, since American securities, and the funds involved in their purchase price, sale price, or income accruals, can be easily smuggled into or out of the United States. It is believed, however, that the enforcement problem will be much simpler so long as the taxes imposed appear to be reasonable. Institutional and large-scale investors cannot afford to be tax-dodgers, unless public opinion is strongly on their side. Among the enforcement problems that must be considered are the following:

(1) A method of blocking the payment of funds to foreigners unless the tax liability of a foreigner on account of security transactions is first paid should be provided. This problem will be somewhat relieved if, as was suggested, we forget about bonds, which are usually in bearer form, and, in the case of stock certificates, make the tax a lien on the certificate itself.

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By blocking at American transfer offices the transfer of certificates held by or on behalf of foreigners, American brokers and security dealers would be caused to exercise exceeding care in withholding yield and capital gains taxes, since the broker could not make valid delivery on the security certificate without payment of the tax.

(2) If a capital gains tax is imposed, it will be necessary to have a record of the price at which the security passes into the hands of a foreigner. So long as the security certificate involved remains in the hands of the American broker for the benefit of a foreign purchaser, the broker can be made responsible for such a record. In case the certificate is actually delivered to a foreigner or his agent, it will probably be necessary to endorse on the security certificate the name of the owner and the price at which the certificate passed into foreign ownership in order to warn all subsequent purchasers, whether American or foreign, that the certificate is of record as foreign-owned and that a recorded change in the ownership is dependent on a clearance of all accrued taxes.

(3) As complete as possible a census of holdings by foreigners should be attempted. Otherwise, foreign holdings acquired prior to the enactment of the taxes now discussed could rather easily avoid any capital gains tax that accrues in the future.

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(4) The delivery of security certificates to customers or to foreign brokers in American street names should be prohibited.

(5) It is presumed that the penalties on Americans who participate in tax evasion in behalf of foreigners will be severe.

(6) In proportion as taxes on foreigners are increased, it will be necessary to prevent them from setting up offices or places of business in this country for the purpose of trading in or holding securities. Under our present tax laws, a foreign partnership or corporation with a place of business in this country is taxed on its income as an American concern would be taxed; and any investment trust or large foreign individual would find it--as is frequently true at present--advantageous to set up an American office in order to avoid taxes on foreign security owners.

In this connection, it may be pointed out that it would be possible to check this type of avoidance by taxing the security income of foreign organizations doing business in the United States as if their security income had been obtained by a foreign owner <u>not</u> doing business in this country. If such a plan runs counter to recent trade treaties negotiated by the State Department, this phase of the problem should be further explored in order to determine whether there may be other

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devices by which foreign corporations could be discouraged from setting up or using established places of business in this country for the purpose of avoiding our taxes on foreign securities.

In any event, the whole problem of the tax clauses being placed in American trade treaties should be thoroughly examined, lest we find ourselves pretty completely bound by treaty obligations. The theory that equality of treatment between Americans and foreigners is obtained by treating foreign corporations doing business in the United States on the same basis as American corporations is open to objection. For instance, we exempt 85 per cent of the dividend income from taxation in the case of an American corporation on the theory that we shall eventually catch the corporation's earnings in the personal income tax of its American stockholders. In the case of a foreign corporation doing business in this country an exemption of 85 per cent of its dividend income is a substantial advantage because resultant earnings are not taxable by the United States under the personal income tax when distributed to the foreign corporation's foreign shareholders. The equality claimed for this procedure is more apparent than real.

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Office Correspondence

Date February 13, 1937

To Chairman Eccles

Subject: Notes on the Nominee System

From Malcolm H. Bryan

Among the proposals thus far tentatively advanced by the writer has been a suggestion originally made by Mr. Gourrich, of the Securities Exchange Commission, that foreign owners of American securities do business through resident, licensed, American nominees. Its advantages would seem to be as follows:

(1) If foreign transactions could be routed through resident, American nominees, a group of citizens directly responsible for the payment of taxes on foreigners would be created, and, if the system were developed along the line of encouraging or requiring the deposit of foreign-owned American securities with American nominees, an aggregation of property would be established within the United States against which our tax enforcement processes could be directed.

(2) The routing of foreign security transactions through responsible, resident nominees would develop a concentrated body of records and census of foreign holdings that should be useful in case the future warranted more direct action or more drastic taxation.

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(3) With the bulk of foreign transactions flowing through the hands of licensed nominees, who would be civilly and criminally liable in cases of tax evasion, the Treasury's supervision could doubtless be considerably reduced for the large bulk of transactions in comparison with the supervision required if the Treasury were compelled as a normal process to deal regularly with the thousands of individuals, partnerships, corporations, brokers, bankers, and investment counsel who might be required to remit funds to foreigners on security accounts. In short, a nominee system should provide a convenient method by which the large fraction of foreign purchasers who would desire to obey our tax laws could be segregated. This should provide a substantial advantage over a situation in which, without American nominees, almost all transactions would be more or less equally suspect, and enforcement efforts tend to be more evenly and more thinly spread over the whole body of transactions.

(4) There would seem also to be an advantage for American business concerns which must remit interest, dividends, or redemptions. They could be permitted to remit funds due foreigners into the hands of American nominees without the delay and routine of clearing each transaction through the Treasury, which would be necessary in the event

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a nominee system were not provided and large avenues of evasion were to be blockaded.

(5) The nominee system would seem to be a convenient means by which securities now held abroad could be brought within the knowledge and observation of the Treasury. If this cannot be accomplished, enforcement on future transactions will almost certainly be made more difficult. Securities smuggled abroad would be merged in the body of securities now in foreign countries and probably returned to this country without difficulty.

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Date February 13, 1937

To Chairman Eccles

From Malcolm H. Bryan

MHB

Subject: Discussion of Capital Inflow Problem

The problem of foreign capital movements to this country has achieved prominence because we have had an inflow of gold of $4,000,000,000 since 1934 and of $600,000,000 since last summer with the flow continuing at the rate of $50,000,000 or more a month. This inflow of gold has already caused the Treasury to adopt a policy of sterilizing gold at the cost of increasing the public debt and the cost of the debt service, and has also caused the Federal Reserve System to double reserve requirements of member banks. The System's power to increase reserves is now exhausted, and the cost to the Treasury with a $1,000,000,000 or so of gold coming in every year will become considerable, particularly if short-time money rates advance. It seems desirable, therefore, to find a means of discouraging the gold movements rather than simply undertaking measures for neutralizing its effect. Furthermore, the measures taken, while they absorb reserves created through gold movements, ~~do not counteract additions to deposits or to the country's money supply, and~~ do not offset the stimulus to speculation in the stock market exerted by the foreign demand for American securities. The presence in our market of a huge volume of foreign-owned securities may cause difficulty if abrupt withdrawals should occur, even though the effect on the credit base can be offset. It may cause an undesirable collapse and liquidation in the stock market, which has reverberations throughout the economic system.

A free movement of capital between countries may be desirable under ordinary circumstances as a means of balancing trade movements. Such a

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movement of capital usually represents a flow of capital to undeveloped countries from older countries that have an excess of savings. Even these movements are likely in the end to cause losses or difficulties, but a movement of capital, resulting in a large movement of gold, when caused by economic and political disturbances in Europe and based to a large extent on the desire of capitalists to have their money in this country where it is safe and where they may profit by our progress towards recovery, is not the kind of a movement that is economically desirable. It shifts capital and reserves from countries that may need them to a country that not only does not need them but that is embarrassed by the inflow.

The undesirable nature of this sort of capital movement has been illustrated on numerous occasions in recent years. In 1931 it resulted in a run on Germany that upset her economy, followed by a run on England that drove England off gold, followed in turn by a run on the United States that, notwithstanding our large gold stock, caused us difficulties by aggravating the deflation then under way. It would be clearly in the interest of international trade and general world recovery if these movements of capital with the concurrent movements of gold were to cease or were reduced to a much smaller magnitude. That European countries are not anxious to have their capital and their reserves flow out is plain. France has had to take several measures to protect itself from the outflow and is now contemplating the necessity of establishing an exchange control. England, which is in the strongest position of any of the great countries in Europe, nevertheless finds it desirable to control and limit the flotation of foreign

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securities in the British market. And yet, securities floated in England are likely to be floated by countries that require capital, while funds going to America reach a capital market in which they are not needed and not wanted. It would, therefore, be an act of international good will in keeping with the spirit of the Tri-Partite Stabilization Agreement if the United States took some measures to restrict the inflow of foreign capital. It is certainly not rational to permit a continuous drain of capital and of gold from European countries to the United States while the European countries are having difficulty in keeping their international payments in balance for the sole purpose of burying the gold in the ground in this country at a substantial cost to the American people, particularly when this movement also contributes to the development of speculation in this country.

The United States could hardly be charged with unfairness if it levied a withholding tax on the security income received by foreigners in this country equal to a similar tax charged Americans in England, nor is there any hardship in imposing a reasonable capital gains tax, since Americans pay one, and since the capital gains already accrued to foreigners in our security markets since 1934 or 1935 are enormous. As is elsewhere noticed, however, it is not proposed to do anything about retroactively taxing gains already accrued, partly in order to avoid any possible charge of bad faith but chiefly because an undertaking to do so would result in a scramble to get out intact before the proposal becomes law. Taxing capital gains that will accrue subsequently to a date specified in the law will not result in a rapid withdrawal of foreign funds, because the gains already earned

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will be secure.

In the final analysis, the proposals are directed towards the purpose of making the American capital market less attractive to foreign investors and, therefore, to make it less of a magnet for capital and for gold than it has been in recent years.

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