Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

# Office Correspondence

Date April 27, 1937

To Chairman Eccles

Subject:

From Malcolm H. Bryan
M. H. B.

Inclosed are two memoranda. The one regarding the Treasury's transfer tax proposal is probably not of much current interest in view of the fact that the Treasury has apparently dropped its own suggestion regarding it.

The memorandum outlining a revised method of putting a capital gains tax into effect has not been read by Dr. Goldenweiser because of the pressure of other work upon him and his prospective absence from town during the next few days. He has been handed a carbon, however, and will forward you later any comments that he believes are required.

Should you desire to pass on the memorandum on the capital gains tax, I should like to talk with you briefly before such action is taken.

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Form F. R. 131

BOARD OF GOVERNORS
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FEDERAL RESERVE SYSTEM

# Office Correspondence

Date March 17, 1937

To Chairman Eccles

Subject: Transfer Tax on Foreigners

From Malcolm H. Bryan

The following paragraphs represent an attempt to set down fair and conservative conclusions regarding the transfer tax that is now being considered as a means for checking capital inflows. The transfer tax is here considered without reference to other taxes that might be used for the same purpose.

1. It is possible to establish a tax on the sale in the United States of securities to and by foreigners (this is understood to be the Treasury proposal) at a rate that will deter the flow of foreign capital into the United States.

(a) Although it may be agreed that any such tax will have some deterrent effect on the capital inflow, the actual rate of tax necessary to repel capital in a large way is not clear and, in the nature of the case, is subject to conflicting opinion.

(b) Purely as a personal judgment, the writer is inclined to doubt that a three per cent transfer rate tentatively suggested by the Treasury (which would amount to six per cent on a completed purchase and sale) will be sufficient, of itself, to reduce the inflow of foreign funds to a degree apparently at present desirable.[1] Such a view rests, of course, upon an emphasis of such factors as: the volume of the current inflow, the prospects for continued business recovery in the United States, the prospects for continued and probably increasing political instability in Europe, and the present level of prices in the chief security markets of Europe as contrasted with the level of security prices in the United States. However, it may be agreed that if a three per cent transfer rate is insufficient to halt the capital inflow, there must exist some other, higher rate—regardless of how high it may need to be—that would in fact deter the inflow to

1/ A memorandum prepared by Mr. Gourrich and Mr. Goldschmidt, of the Securities Exchange Commission, vigorously concurs in this opinion. Mr. Bradley, of the Board's Security Loans Division, feels that a three per cent transfer tax might have a considerable effect.

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whatever extent is desired. The apparent effectiveness of any rate on transfers would be increased, moreover, by additions to the present withholding rates on interest and dividend income.

2. Since the tax will be levied (and could be enforced) only when transactions are consummated in American markets, foreigners can be expected to conduct their purchases and sales in foreign markets whenever possible. It may be anticipated, therefore, that foreign business in American markets will be confined to net movements of securities into or out of the United States and arbitrage.[1/] No plan to avoid this result has thus far been proposed, and, while it might be possible, as has been suggested, to prevent the export of American securities, the ease with which trust certificates or other representatives could be issued for trading purposes abroad would appear to allow ample room for avoidance.

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1/ If the price of a security in the United States were $100 and the tax $3, no foreigner would purchase the American security in the United States so long as the price in the foreign market was less than $103, since, at any price under $103, his net cost in the foreign market would be less than his net cost in the American market. Using the same illustrative figures, no foreigner would sell the American security in the United States so long as the price abroad was more than $97, since, at any price above $97, his net proceeds would be greater in the foreign market than his net proceeds in the American market. In other words, whenever foreign markets were buying American securities on balance, the foreign price of those securities would be bid up to the American price, plus tax; whenever foreign markets were selling American securities on balance, the foreign price would decline to the American price, minus tax. Thus, when the foreign price in this illustration were between $103 and $97, it would be to the interest of both foreign buyers and foreign sellers to confine their transactions to foreign markets exclusively; and only when foreign prices went to or beyond the "security import point" or the "security export point" would there be foreign dealings in American markets, which is another way of saying again that only transactions involving net movements would occur in the United States or be taxed by this government.

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(a) Mr. Bradley, of the Security Loans Division, estimates that the maximum amount of trading that could have been removed from American to foreign markets in 1936 by a transfer tax of the sort proposed would have been ten per cent of the total volume of business done by members of the American security exchanges.[1] (Cf. the attached memorandum by Mr. Bradley.)

(b) American brokers can say that a transfer tax on foreign trading in American securities will divert a portion of the trading to their competitors overseas. The answer to this argument must rest on general considerations of public policy. The problem--leaving out of account other possible taxes--seems to turn on whether or not the public interest in this case warrants the use of a tax device that overrides the private interest of a particular group of American business men. The factors involved in a judgment on this problem go beyond the field of taxation as such and are so imponderable in character as to make a so-called expert opinion peculiarly liable to error. However, it is fair to emphasize that in presenting a transfer tax to Congress we must be prepared to meet the arguments of American brokers with counter considerations of equal weight; and it will be necessary to demonstrate that other available forms of taxation are more objectionable.

Much the same sort of comment may be made regarding the discriminatory features of the transfer tax suggestion. The tax clearly discriminates against foreigners; but the broad question of whether or not discrimination is defensible must again be based upon considerations of public policy in relation to the immediate and the long-term national interest; and it does not seem apparent that foreign capital can be repelled in bulk without taxes on foreigners of such weight that they will necessarily be discriminatory, regardless of the kinds of taxes adopted. At the same time, in proposing the transfer tax, we must be prepared to demonstrate why it is preferable to taxes that are at least less obviously discriminatory.

3. Certain administrative difficulties are apparent in any attempt to enforce a transfer tax on foreigners.

(a) Bearer certificates can be moved from American markets to foreign markets and back again with no evident, easy, or certain means of detection. A detection process that would eliminate a considerable possibility of evasion would need to set up more rigid

1/ The figure of ten per cent would have been eight per cent if it omitted arbitraging operations, which would in fact apparently be largely unimpeded after the price levels in the foreign markets had adjusted themselves to the tax.

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requirements than are now customary in determining the identity of persons offering to buy or sell bearer securities. It may be remarked in passing that the administrative difficulties of a transfer tax on bearer certificates are essentially the same as the difficulties of a capital gains tax in regard to similar securities.

(b) The enforcement problem in connection with bearer certificates exists chiefly with respect to bonds. It would seem possible in the case of equity securities to prevent the delivery to customers of certificates in street names, endorsed in blank, which appears to be the method of converting equity securities into what amounts to bearer form. The abolition of this practice, which is not usual in any event, could probably be accomplished either by direct prohibition or by a prohibitive tax; and its abolition would apparently work no appreciable hardship on customers or brokers. Equally satisfactory methods of effecting delivery are available and are ordinarily used.

(c) There is a considerable possibility of evasion of the tax by foreigners who have the beneficial interest in equity securities now held in American names or in bearer securities now in the hands of Americans. A census of such American holdings in behalf of foreigners would appear to be indicated.

(d) Means will be necessary to secure the tax when future purchases by Americans are made for the beneficial interest of foreigners. This may not be a serious problem so long as the rates under the transfer tax remain lower than the taxes Americans would be required to pay in accordance with our several domestic taxes; but it must be noticed that the difference in price of securities between United States and foreign markets will create a continuous incentive to smuggling operations.

(e) Unless some alteration of our general rule for taxing a foreign corporation or partnership business in this country in the same way that an American corporation or partnership is taxed, foreign purchasers could avoid the transfer tax by setting up an office or place of business in this country. The seriousness of the problem presented by this avenue of avoidance will depend upon the rate of the transfer tax and intention of the foreign purchaser. If the foreign purchaser intends buying securities for income purpose over a long period, without reference to capital gains, the transfer tax would create an additional reason (additional to the present withholding tax) for setting up an office or place of business in this country. If the foreign purchaser is primarily a speculator for capital appreciation, the incentive to setting up a place of business in the United States would be eliminated because of the American domestic tax on capital gains and because the transfer tax can

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be so largely avoided by transactions conducted on foreign exchanges.

4. A judgment regarding the proposal that the rates of the tax should be subject to Presidential discretion must rest on the degree of importance attached to the tax as an instrument of national monetary control.

(a) If the tax is not regarded as an especially important element in national monetary policy, if it is to be regarded as minor or incidental, then the arguments against discretion are probably greater than the arguments for discretion. Discretionary power would be contrary to the usual notion that a tax should be certain; it would make the application of the tax somewhat more difficult to disguise as a casual or friendly action; it would weaken any possible argument for the levy on grounds of tax equity; and the exercise of the Presidential discretion provided for might be the cause of fresh diplomatic representations on each occasion of its exercise.

(b) On the other hand, if the tax is in fact to be regarded as an important instrument of control, the arguments in favor of discretion are forceful and probably decisive. Considerations regarding tax certainty lose much of their weight when taxation is used primarily for economic control and not primarily for revenue; the inability to foresee the effect of any particular rate should indicate the desirability of flexibility in the rate; and the possible alteration of conditions affecting the inflow would also indicate the advantages of an easy means of adjusting the rate of tax to the changed conditions. The same considerations apply in connection with possible foreign retaliation. The net judgment of the writer is that, if there is a determination to deter foreign capital and if it is to be repelled exclusively by a transfer tax imposed originally at a rate of three per cent, some flexible method for raising the rate above that figure would be likely to prove useful.

5. A memorandum by Mr. Gourrich and Mr. Goldschmidt, of the Securities Exchange Commission, points out that the desirability of repatriating present or future foreign holdings of American securities may change considerably. At the present time, it would seem important to make the

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repatriation of foreign-held American securities as easy as possible, which would indicate that a tax should not be placed on the transfer of American securities from foreign to American ownership but only on the purchase of securities by foreigners. On the other hand, should developments cause or threaten to cause an abrupt or disorderly wave of foreign selling, it might be desirable to impede the repatriation of American securities, and, under such conditions, a tax--or an increase in the tax--on sales by foreigners would be desirable.

(a) Since an impediment to foreign selling of American securities is not now desirable, the possibility of placing a transfer tax only on purchases by foreigners should be considered. There would thus be no tax on foreign sales of securities to stand in the way of a net outflow of foreign capital. The rate of such a purchase tax could be made sufficient to have the same effect in deterring capital inflows as is to be ascribed to the present proposal for a tax of three per cent on both purchases and sales. It must be noticed, however, that the presence or absence of a tax on foreign sales is largely unimportant so long as there is a net inflow of foreign capital to the United States, for foreign sellers will tend to be entirely tax free because of the difference in price between identical securities in the American and the foreign markets. Probably the chief effect of a tax on sales at the present time would be to stop foreigners from certain amount of "switching".

(b) A reduction in the immediate inflow of capital, or even a net outflow, could probably be secured by postponing the effective date of the tax on foreign sales until some months after the effective date of the purchase tax. A certain number of foreigners now owning American securities would probably anticipate the time when there would be a net movement of securities from the foreign to the American markets and when the foreign markets would thus be at a discount in comparison with the American market by reason of the tax on sales. They might thereby be induced to liquidate their American holdings before the tax went into effect. Foreign selling of American securities now owned by foreigners would in that way probably satisfy in a measure the demand of other foreigners for American securities and thus reduce the present rate of capital inflow; and the selling might, indeed, be sufficient for some months to cause a repatriation of American securities and a consequent outflow of capital now in the United States.

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6. Since the tax will be a proportional fraction of the value of all types of securities, it will probably leave each type of security investment in approximately its existing position of relative desirability. It is difficult to foresee, therefore, that there will be, simply as a result of the tax, any substantial shift in the present distribution of the kinds of securities purchased by foreigners.

(a) The foregoing statement must be slightly qualified to allow for the enforcement factor. To the degree that the tax is less enforcible on bonds, which are in bearer form, there will be a tendency for bonds to become a more desirable form of investment by foreigners. This tendency will depend upon the weight of the tax and the degree of variation in its enforcibility. Moreover, the tax will impede switching from one investment to another and may as a result cause foreigners to concentrate their holdings in better grade securities.

(b) If the tax causes a shift in the kind of trading done by foreigners, its apparent effect would be to lessen the desirability of relatively quick trades for a series of small profits; and, conversely, it would appear to increase the desirability of purchases that are to be held for income purposes, or large profits, over the long term. This possible effect of the tax can be easily exaggerated, however, since trading by foreigners for short-term gains will, after the imposition of the tax, simply be carried on in foreign markets. Moreover, during periods when there is a consistent flow of securities from the United States to foreign markets or vice versa, the foreign short-term trader will be largely tax free because of differences in price between the foreign and the American markets. Apparently the only additional risks caused to the short-term trader will be those that derive from increased sensitiveness and fluctuations in the foreign market during periods when there is neither a consistent flow of securities from the United States to foreign markets nor from foreign markets to the United States.

It is to be noticed that there is likely to be an almost entire concentration of foreign in-and-out trading on the particular American issues that attract foreign purchases in sufficient bulk to cause listing on foreign markets.

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BOARD OF GOVERNORS
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# Office Correspondence

Date April 27, 1937

To Chairman Eccles

Subject: Taxation of Capital Inflows

From Malcolm H. Bryan
M. H. B.

I. This memorandum embraces two chief features:

(1) A brief restatement of the opinion that a tax program for deterring the inflow of foreign capital should consist of at least two kinds of taxation, (a) a withholding tax on interest and dividends and (b) a tax on capital gains; and,

(2) An attempt to devise a method by which an essentially satisfactory capital gains tax can be enforced without too great a degree of administrative complexity.

II. The tax program now proposed is as follows:

(1) A tax on interest and dividends paid to or for the benefit of foreign individuals or foreign corporations.

(a) The rates required to effect a desirable deterrent to foreign capital are, of course, subject to reasonable differences of opinion. The rate here suggested for dividends on equity securities is 20 per cent and for interest on non-equity securities 15 per cent.[1]

While no absolutely compelling reason for this differential treatment can be adduced, probably a distinction in rate between dividends, on the one hand, and interest, on the other hand, can be justified on certain grounds: the fact that holders of interest bearing securities are likely to be (and to have been) long-term investors, with a long-term stake in the country, and the fact that, if a boom impends, the owners of such securities do not stand to secure as much from the American economy as owners of common stock.

1/ The intention is to use the term 'equity securities' as it is defined in the Securities Exchange Act. Further examination of this usage may indicate the desirability, for present purposes, of slight changes in the definition, since equity securities in the Act include certain bearer securities.

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

(c) The inflow of foreign capital might be deterred to the extent apparently required in present circumstances by the exclusive use of a yield tax. To depend entirely upon a yield tax for a deterrent, however, would involve very stringent rates and would place the burden of discrimination squarely upon the class of foreign investors who can fairly claim that they should be least discriminated against.

(2) A capital gains tax on the profits secured by foreigners from the purchase and sale of equity securities.

(a) The original proposal was for a tax at some rate between 10 and 25 per cent. This proposal is repeated with the expression of a preference for a rate nearer the higher figure than the lower.

(b) The tax on capital gains is suggested because, in its absence, foreigners would be left unimpeded to direct their American investment operations solely toward prospective capital gains in non-dividend-paying securities.

(c) The capital gains tax is intended to be applied at a flat rate because: (1) progressive taxes 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; (2) 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; (3) flat rates permit the payment of the taxes without reference to any arbitrary income period, such as a year; and (4) 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.

(d) 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 considerable amount of foreign in-and-out trading in our markets, which would be desirable. The foreign operator who expected to take many losses but to secure a profit on balance would find his opportunity of profit impaired.

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(3) No additional tax on transfers is suggested.

(a) The original proposal for a transfer tax was designed to implement the nominee system and other features of the program of taxation heretofore submitted for the Treasury's review and consideration (January 19, 1937).

The transfer tax, as is indicated in the context of previous proposals, was considered the least satisfactory of the taxes discussed; and, in the present memorandum, the elimination of the nominee system, the penalty rate structure, and other elements of the original program, appear also to permit the elimination of the transfer tax without loss.

With regard to the proposal of the Treasury (February 24, 1937) that the entire burden of repelling foreign capital be placed upon a transfer tax, an opinion has been developed in moderate detail in the attached separate memorandum. The proposal does not appear to be the best of possible alternatives.

III. Objection has been raised to the administrative complexity of a capital gains tax. This paper develops the opinion that a useful type of capital gains tax on foreigners can be designed with sufficient administrative simplicity to warrant its use.

The administrative difficulties connected with taxing capital gains in the hands of foreigners exist chiefly because of bearer certificates. Such certificates can be easily smuggled into or out of the United States; and an attempt to identify their owners, to detect transactions, and to assess the taxable gains involved, necessarily requires a complex administrative machinery.

If no effort were made to tax capital gains from bearer certificates, or if the issue of bearer certificates were eliminated, a fairly simple and easily administered tax on the capital gains accruing to foreigners from transactions in American securities would seem possible. Since most bearer certificates are bonds, this sort of an attack on the problem

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is defensible. In the first place, capital gains arising from bonds are relatively unimportant (except in the earlier stages of recovery from a severe depression). Their omission can be especially argued for at this time when most of the capital gains to be expected on bonds have already accrued as a result of low interest rates and of preceding improvement in business. In the second place, the occasional delivery to customers of equity securities endorsed in blank by street names (thus essentially in bearer form) could be stopped without an important disturbance of any present practice of the security markets. It is in this connection with profits from equity securities that large capital gains in the security markets are ordinarily to be identified.

IV. It is to be clearly understood that in the following proposals for a simplified tax on foreign capital gains, there is no pretense that an entirely perfect system has been devised. The point of view expressed is that a simplified system of effecting the tax is worth careful consideration, and that, if applied at sufficiently stringent rates in conjunction with a sufficiently increased tax on interest and dividends, the flow of foreign capital into American securities can be reduced by an indeterminate but substantial amount and the inflow of gold probably also reduced.

Briefly, the proposals now made for a capital gains tax are as follows:

(1) Confine the tax on capital gains by foreigners to such gains as arise from transactions in American equity securities.

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(2) Measure the taxable gain, if any, by the difference between the purchase price and the sales price. Let the purchase price be the figure at which a foreign owner has acquired the security from an American seller; and let the sales price be the figure at which the security is next resold by any foreign owner to an American. Ignore intervening transactions between foreigners (i.e., involving no transfer to or from an American) if such sales are not accompanied by a recorded change of ownership at the transfer office of the American issuing corporation. In the case of American securities now held by foreigners, establish as the purchase price the value of the security as of some date fixed by statute, say, for instance, the date of the enactment of the tax.

(3) Enforce the tax by the following devices:

(a) Make the tax a lien against the certificate itself.

(b) Prevent all American transfer offices from transferring securities from foreign to American ownership without paying the tax or having evidence in appropriate form from the Treasury that the accrued tax liability of the foreign owner has been paid.

(c) Identify foreign ownership in the following ways:

1) When brokers or others, after the effective date of the tax, deliver equity securities to foreigners or their agents, require that the security shall be delivered in the name of the foreign purchaser and that the security shall be stamped with a notice showing it to have been purchased for foreign account, its purchase price, and the fact that no change of ownership at the transfer office of the corporation will be permitted without the payment of any capital gains tax that shall accrue.

2) With regard to American securities already in foreign ownership on the effective date of the tax, secure from brokers, transfer offices, bankers, trustees, and others, a census as complete as possible, and proceed with these securities in accordance with (b) above.

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(d) When American brokers effect purchases and sales of equity securities for foreign account, and the securities remain in the hands of the brokers, make the broker responsible for paying the tax and require him to deduct the tax payment from the proceeds of the transaction.

(e) Prohibit brokers from the present occasional practice of delivering to their customers certificates in street names, endorsed in blank.

V. Examination of the foregoing suggestions for a capital gains tax discloses that substantial reliance, so far as enforcement is concerned, is placed upon the fact that the tax is made a lien against the certificate itself. The tax in this sense is _ad rem_ and is similar to a property tax or customs duty.

It is on the basis of such a provision that the administration of a capital gains tax can be freed of many administrative complexities. The provision would tend very effectually to prevent American purchasers from accepting delivery of an equity security certificate without its clearance through a transfer office and its emergence as a clean, tax-freed certificate in the name of the purchaser. Since this is in any event the usual practice in connection with the delivery of securities to customers, no important alteration in market procedure would be caused.

If the tax is not made a lien _ad rem_, Americans could purchase endorsed securities from foreigners or in foreign markets at the discounts that will probably prevail for foreign-held securities and present them to transfer offices or to other Americans on the allegation that the tax liability rests on the former foreign owner who is beyond the jurisdiction of the United States.

As for transactions in American securities occurring between two

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foreigners, the probable result will be that the purchaser will pay the market price for the security less the accrued tax liability. A good many foreign purchasers from other foreigners are likely, however, to insist on the clearance of purchased certificates through an American transfer office, payment of accrued taxes, and issuance of a clean certificate in the new purchaser's name before accepting delivery.

A proper question is whether or not the levy of the tax as a liability against the certificate itself will result in eventually putting afloat in the United States a considerable body of securities whose titles are clouded by tax liabilities. A step by step elimination of all possibilities in this connection would unduly expand the size of this paper. After exploration of the problem, however, it may be said in passing that apprehension on this score would apparently be groundless. Americans would be unlikely to receive certificates clouded by a tax liability except when an American purchaser, through private negotiation, accepted from a foreigner an endorsed certificate in the foreigner's name. Americans who purchase through ordinary banking or brokerage channels could be easily protected by provisions of law against the delivery of non-tax-freed certificates, and American security dealers would in turn be self-protected because funds arising from their sale of securities for foreigners would pass through their hands.

The most important sources of evasion in connection with a capital gains tax levied in the proposed manner would appear to lie in the following directions:

(a) Repatriation of American securities now held by foreigners in American names or in street names, if these securities were not disclosed by census.

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(b) Sale to foreigners of securities now held by Americans in street names.

(c) Acquisition of American securities by foreigners in the future through Americans acting as foreigners' agents or resident foreigners acting as agents of non-resident foreigners.

(d) Resident foreign corporations and partnerships.

Of these avenues of evasion, (a) and (b) would probably not be large enough to destroy the purposes of the tax and would gradually exhaust themselves. As for foreign acquisition of American securities in the future by means of American or resident foreign agents, heavy penalties, a check of income tax returns, and probably other devices, would materially discourage the practice. The resident foreign corporation or partnership can probably be treated by one of the methods outlined in the memorandum of January 19, 1937 (pp. 11 ff.).

It is to be specifically noted that this tax program does not deal with foreign short-term balances.

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