

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date June 22, 1945

To Chairman Eccles

Subject: Capital Gains Tax Exemption for

From R. A. Musgrave *R.A.M.*

Nonresident Aliens

I discussed the matter with Mr. Blough and Mr. O'Connell, the General Counsel of the Treasury. I have the following report to make:

The Treasury people are acutely aware of the problem and its implications in very much the same terms in which you stated it. Evidently the matter broke a few weeks ago and the Bureau of Internal Revenue has been asked to prepare an opinion about what can be done. The Treasury has been requested to report on the matter by several members of the Ways and Means Committee, and there seems to be an all-around agreement that something should be done promptly.

The problem in brief is this: The law now provides that resident aliens are taxed like any other resident citizen, but special tax treatment is given to nonresident alien individuals and corporations. Nonresident aliens pay a flat tax of 30 per cent on their income if less than \$15,400 is received; they pay the regular full rate tax if their income is higher. However, the law provides that "nonresident aliens not engaged in trade or business within the United States" do not report their capital gains as taxable income. Historically, this provision goes back to the Revenue Act of 1936 and has since been maintained with slight variations. The main arguments made at that time were that:

1. taxation of capital gains of nonresident aliens is impracticable because of lack of jurisdiction over such persons;
2. it is impossible to identify the alien with his domestic security transaction; and
3. other countries do not have capital gains taxes which apply to security transactions of American citizens, and hence reciprocal treatment should be given to aliens here.

I understand that behind this there was a substantial Wall Street opinion in favor of the provision, because it was hoped that the exemption would attract foreign capital to the New York Exchange. I understand that Mr. Schram favored continuation of this proposal on much the same grounds as late as 1939. But for some reason nothing was done to correct the situation during the course of the war when the New York Exchange turned out to be the only active stock market in the world and a sizable group of nonresident aliens with substantial funds began to play the market.

Two approaches to the problem can be taken:

1. new legislation, and
2. administrative changes in the provisions of the Revenue Code which would tighten up regulations.

Mr. Blough and Mr. O'Connell tell me that they consider it desirable to try the second way first. If no adequate results can be obtained, legislation will be recommended. Mr. O'Connell feels that a good deal may be done by tightening regulations. As it stands, the Code exempts "nonresident alien individuals not engaged in trade or business within the United States". The Code explicitly states that transactions in commodities on stocks or securities through a resident broker or agent may be undertaken without the individual being "engaged in trade". Hence, little can be done in tightening this part of the regulations without legislation. However, the problem might be attacked by tightening the definition of what constitutes a "nonresident alien". The Revenue Code now defines a nonresident alien individual as an individual whose residence is not within the United States and who is not a citizen of the United States. It goes on to say that an alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax and that "if he lives in the United States and has no definite intention as to his stay, he is a resident". I am told that the Bureau's practice has been to leave it up to the alien to decide whether he wishes to consider himself a resident or nonresident and, hence whether he wishes to make capital gains tax returns or not. It seems to me that the Revenue Code, even in its present formulation, provides adequate basis to declare most of the people in question to be resident aliens for purposes of the tax law. If this can be done, the Bureau may clamp down on them and may succeed in forcing back-payment of taxes on gains made during recent years. This would be an advantage over the new legislation approach, which could hardly apply retroactively for the entire period.

Mr. O'Connell told me that he expects a report on the matter within a very few days and that he will keep us informed about progress made.