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The United States Interest Equalization Tax

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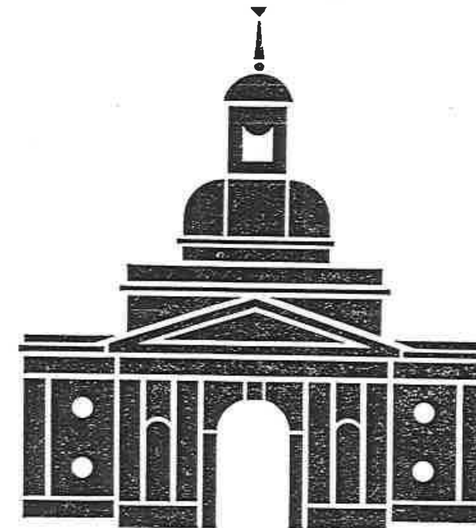

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* * * ARTICLES * * *

THE UNITED STATES INTEREST EQUALIZATION TAX

RICHARD D. POMP *:

In 1964, the Bulletin presented an article on the newly proposed United States Interest Equalization Tax (See Volume XVIII, p. 3). Although the tax was intended to be only a temporary measure, it has been continually extended and amended. The following article describes the present contours of the tax.

I. INTRODUCTION

The United States interest equalization tax (IET) [1] is a one-time tax levied on the acquisition of certain foreign securities. It was proposed by President Kennedy [2] in order to reduce the United States balance-of-payments deficit by restricting portfolio investment. [3] Prior to the enactment of the tax in 1964, [4] many foreign debt issues were attracting a substantial amount of dollars because of their high interest rates. The IET attempts to equalize the yield of foreign issues with that of domestic issues and thus diminish the attractiveness of foreign obligations.

The tax was introduced as a temporary measure and was originally scheduled to expire in 1965. The continuing Unted States balance-of-payments deficit, coupled with the IET's success in reducing foreign investment, has resulted in six extensions of the tax. The IET is now scheduled to expire on July 1, 1974, but current international monetary conditions may necessitate another extension.

II. TAXABLE EVENT

The IET is a tax on the acquisition by a United States person of stock of a foreign issuer [5] or of a debt obligation of a foreign obligor (if such obligation has a period

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1. INT. REV. CODE of 1954, §§ 4911-4931.
2. President's Special Message on Balance of Payments, 109 CONG. REC. 12806 (1963).
3. Portfolio investment is generally considered to be a less than 10% interest in a corporation or partnership. Foreign direct investment (i.e., a 10 % or more interest in a corporation or partnership) is regulated by the Department of Commerce's Foreign Direct Investment Program. See Section VII A, infra.
4. Act of September 2, 1964, 78 Stat. 809. The tax applies retroactively to July 19, 1963.
5. Although the IET was in response to the higher interest rates of foreign debt obligations, it was made applicable to the purchase of equity issues in order to prevent a substitution of stock for debt.

remaining to maturity of one year or more). Although the tax is imposed on the United States person acquiring the foreign securities, it is normally passed on to the seller or borrower.

The tax is levied on the actual value of the securities acquired. [6] In general, the actual value is determined by the consideration that would have been paid by a purchaser in an arm's length transaction.

A. *Acquisition*

The term "acquisition" includes any purchase, transfer, distribution, exchange, or other transaction by virtue of which ownership is obtained. [7] In order to reach those situations that are arguably outside the definition of acquisition but which should nonetheless be taxable under the rationale of the IET, the statute specifies that certain transactions constitute acquisitions. For example, a contribution to the capital of a foreign corporation or partnership is considered to be an acquisition of stock. [8] The acquisition of securities of a domestic corporation or partnership availed of for the principal purpose of obtaining funds for a foreign issuer or obligor is treated as the aquisition of foreign securities. [9]

On the other hand, certain transactions that do not result in an outflow of dollars are specifically excluded from the definition of acquisition. Thus stock dividends and transfers by legacy or gift are not treated as acquisitions. [10]

B. *United States persons*

"United States persons" include citizens or residents of the United States, partnerships or corporations created or organized in the United States, agencies or wholly-owned instrumentalities of the United States, States or political subdivisions thereof, and certain estates and trusts. [11]

C. *Stock or debt obligations*

The term "stock" includes any stock, share, or other capital interest in a corporation, or any interest of a partner in a partnership. Stock includes an option to acquire stock. A debt instrument whose terms allow it to be converted to stock within 5 years from the date on which interest begins to accrue is also considered to be stock. [12]

The term "debt obligation" includes any indebtedness, whether or not represented by a bond, note, or other writing, and whether or not bearing interest. [13] Annuities or obligations of an insurer to pay under an insurance contract are not considered to be debt obligations.

As mentioned above, debt obligations are taxable only if the "period remaining to maturity" is at least 1 year. [14] In general, the period remaining to maturity begins on the date of the obligation's acquisition and ends on the date of payment. [15] A debt obligation having no fixed or determinable date for the payment of principal is treated as having a period remaining to maturity of 28½ years. Debt obligations that are payable on demand (e.g., certain bank deposits) are deemed to have a period remaining to maturity of less than 1 year.

D. *Foreign issuer or obligor*

The term "foreign issuer or obligor" includes any nonresident alien individual and any corporation, partnership, estate, or trust that is not a United States person. Also included is any international organization of which the United States is not a member and any foreign government or political subdivision, agency, or instrumentality thereof.

Under certain circumstances, a United States person may elect to be treated as a foreign issuer or obligor. See Section VII, infra.

III. RATES

A. *Debt obligations*

The rates of tax levied on the acquisition of foreign debt obligations are a function of the period remaining to maturity. Specifically, the tax rates are intended to equal the present value of the difference between European interest rates and the United States interest rate. [17] In this manner the IET attempts to equalize foreign and domestic interest rates.

The base rates of tax are specified in the statute. [18] Because there is fluctuation in both the foreign and domestic interest rates, the President has the authority to increase or decrease the base rates in order to achieve the balance-of-payments objective of the IET. [19] Statutory ceilings are provided above which the tax may not be increased [20] but no floors are provided; the President thus has the power to effectively eliminate the tax.

In 1969, President Nixon set the present rates as indicated in the table on p. 6. [21]

B. *Stock*

The tax on the acquisition of foreign stock is 11.25% of the stock's actual value; thus stock is treated as long-term debt.

IV. EXEMPT TRANSACTIONS

Although the basic principles of the IET can be stated simply, the actual legislation is quite complex. This complexity arises from a profusion of exemptions and elective provisions. These provisions exempt from the tax those areas of foreign investment where the United States balance-of-payments is not adversely affected. In addition, they exempt investment that is not motivated by interest rate differentials. The exemptions also avoid impairing normal commercial transactions and reduce unnecessary hardship. Finally, they avoid conflicts with other national objectives, for example, aid to less developed countries. Many exemptions are quite technical and affect only special interest groups. This Section discusses the exemptions that have more general applicability.

6. INT. REV. CODE of 1954, § 4911 (b). Hereafter, all references are to this Code unless otherwise indicated. A special rule applies where securities are acquired as the result of the surrender, extension, renewal, or conversion of previously owned securities, or the exercise of an option or similar right. See § 4913 (a).
7. § 4912 (a).
8. § 4912 (b) (2).
9. § 4912 (b) (3).
10. § 4914 (a).
11. § 4920 (a) (4).
12. § 4920 (a) (2).
13. § 4920 (a) (1).
14. The President has the power to levy the tax on foreign debt obligations having a period remaining to maturity of less than 1 year. See § 4921 (a).
15. § 4920 (a) (7).
16. § 4920 (a) (3).
17. H. R. REP. No. 1046, 88th Cong. 1st Sess. 11-12 (1963).
18. § 4911 (b) (1). With respect to debt obligations, the base rates range from 1.05% (for a maturity period between 1 and 1¼ years) to 15% (for a maturity period exceeding 28½ years). The base rate for stock is 15%.
19. § 4911 (b) (2).
20. The ceiling is 22.5% in the case of stock and ranges from 1.58% (for a maturity period between 1 and 1¼ years) to 22.5% (for a maturity period exceeding 28½ years) in the case of debt obligations. See § 4911 (b) (2).
21. Exec. Order No. 11464, 1969-1 CB 292.

If the period remaining to maturity is:	The rate of tax as a percentage of actual value is:
At least 1 year, but less than 1¼ years	0.79
At least 1¼ years, but less than 1½ years	0.98
At least 1½ years, but less than 1¾ years	1.13
At least 1¾ years, but less than 2¼ years	1.39
At least 2¼ years, but less than 2¾ years	1.73
At least 2¾ years, but less than 3½ years	2.06
At least 3½ years, but less than 4½ years	2.66
At least 4½ years, but less than 5½ years	3.26
At least 5½ years, but less than 6½ years	3.83
At least 6½ years, but less than 7½ years	4.35
At least 7½ years, but less than 8½ years	4.88
At least 8½ years, but less than 9½ years	5.33
At least 9½ years, but less than 10½ years	5.78
At least 10½ years, but less than 11½ years	6.23
At least 11½ years, but less than 13½ years	6.83
At least 13½ years, but less than 16½ years	7.73
At least 16½ years, but less than 18½ years	8.51
At least 18½ years, but less than 21½ years	9.19
At least 21½ years, but less than 23½ years	9.79
At least 23½ years, but less than 26½ years	10.31
At least 26½ years, but less than 28½ years	10.76
28½ years or more	11.25

A. *Prior United States ownership*

Since transactions between United States persons do not affect the balance-of-payments, an exemption is provided for foreign securities acquired from a United States person.[22] The seller must have been a United States person throughout his period of ownership (or since July 18, 1963) and must have either paid the IET with respect to his acquisition of the securities or acquired them tax-free.

B. *Investments in less developed countries or areas*

To avoid deterring the flow of private capital to less developed areas, an exemption is provided for the acquisition of:[23]

22. § 4918 (a). An exemption from the IET is provided for any acquisitions made by a resident (who is not a United States citizen) during the first 90 days after becoming a resident. § 4914 (b) (15). On a subsequent disposition of the securities, the resident is not considered as a United States person. § 4914 (j). Therefore, if the resident were to sell the securities, the purchaser could not claim an exemption on the grounds of having purchased them from a United States person.

23. § 4916 (a).

(1) debt obligations issued or guaranteed by the governments (national or local) of a less developed country,[24] or by an agency or instrumentality of such governments; (2) stock or debt obligations of a less developed country corporation with the exception of certain shipping corporations (discussed infra); or (3) debt obligations issued by an individual or partnership resident in a less developed country in return for money or other property which is used wholly within one or more less developed countries.

Prior to 1973, stock or debt obligations of all less developed country corporations (LDCC's) were exempt from the IET. In general, the LDCC's are those foreign corporations that have significant operations within less developed countries.[25] Included, however, are the so-called less developed country shipping corporations. These are foreign corporations that derive a large percentage of their income from the operation of ships or aircraft registered in less developed countries and whose stock is substantially owned by United States persons or residents of those countries. Experience has shown that these types of shipping corporations do not make capital investments in the less developed countries and thus their securities should not be exempt from tax. Accordingly the 1973 Interest Equalization Tax Extension Act (1973 Act) taxes the acquisition of securities issued by these shipping corporations after January 29, 1973.[26]

C. *Direct investments*

1. *In foreign corporations or partnerships*

The acquisition of a foreign corporation's securities is exempt if immediately after the acquisition the United States person owns (directly or indirectly) at least 10% of the total combined voting power of all classes of stock of the foreign corpora-

24. The following areas and countries are designated as less developed countries for purposes of the IET:
(1) All foreign countries (including Trust Territories) in existence on or after June 11, 1966, other than Australia, Austria, Belgium, Canada, Denmark, Federal Republic of Germany, France, Iran, Iraq, Ireland, Italy, Japan, Kuwait, Kuwait-Saudi Arabia Neutral Zone, Libya, Liechtenstein, Luxembourg, Monaco, Netherlands, New Zealand, Norway, Portugal, San Marino, Saudi Arabia, Spain, Sweden, Switzerland, Union of South Africa, United Kingdom, and any foreign country within the Sino-Soviet bloc (defined infra).
(2) A territory, department, province, and possession (other than Abu Dhabi, the Bahamas, Bahrain, Bermuda, Hong Kong, and Qatar), of any foreign country existing on or after June 11, 1966, except a foreign country within the Sino-Soviet bloc, if the territory, department, province, or possession is overseas from the foreign country of which it is a territory, department, province, or possession; and
(3) Puerto Rico and all possessions of the United States.
The term "foreign country within the Sino-Soviet bloc" includes Albania, Bulgaria, any part of China which is dominated or controlled by International Communism, Cuba, Czechoslovakia, Estonia, Hungary, any part of Korea which is dominated or controlled by International Communism, Latvia, Lithuania, Outer Mongolia, Poland (including any area under its provisional administration), Rumania, Soviet Zone of Germany and the Soviet Sector of Berlin, Tibet, Union of Soviet Socialist Republics, the Kurile Islands, Southern Sakhalin and areas in East Prussia, which are under the provisional administration of the Union of Soviet Socialist Republics, and any part of Viet Nam which is dominated or controlled by International Communism. Exec. Order 11071, 1963-1 CB 137; Exec. Order 11224, 1965-1 CB 507; Exec. Order 11285, 1966-2 CB 480.

25. The precise definition of a less developed country corporation for purposes of the IET is rather elaborate. See § 4916 (c) (1).

26. § 4916 (e). Special rules apply to commitments existing before January 29, 1973.

tion.[27] The exemption also applies to securities acquired from a foreign partnership, if immediately after the acquisition the United States person is entitled to at least a 10% interest in the partnership's profits.[28]

Direct investment in foreign corporations or partnerships is exempted from the IET because such investment is usually concerned with long-range profitability and market position, rather than interest rate differentials.[29] It should be noted, however, that foreign direct investment is regulated by the Office of Foreign Direct Investment.[30]

In order to prevent tax avoidance, (e.g., by using a more than 10% owned foreign corporation to acquire foreign securities) the exemption is denied if the foreign corporation or partnership (other than commercial banks, underwriters, and certain domestic corporations electing to be treated as a foreign corporation)[31] is formed or availed of for the principal purpose of acquiring foreign securities that would have been subject to the IET if acquired directly by the United States person.[32] The exemption is also denied if the securities were acquired with an intent to sell any part of them to United States persons.

2. *In the United States*

Prior to 1973, foreign corporations or partnerships wishing to make direct investments in the United States could not raise funds from United States persons without the transaction being subject to the IET. In order to encourage foreign investment within the United States, the 1973 Act exempts foreign stock or debt obligations issued for the purpose of financing new or additional direct investment in the United States if, inter alia:[33]

(1) at least 50 percent of the total funds required for the direct investment will come from sources outside the United States;

(2) such investment will be made for a period of at least 10 years; and

(3) during such 10-year period the aggregate amount of all investments in the United States by the foreign issuer or obligor will at no time be reduced below the aggregate amount of such investments as determined immediately after the investment to which the exclusion applies.

D. *Acquisitions required under foreign law*[34]

If a United States person doing business in a foreign country is required by the laws of that country to hold a minimum amount of securities, their acquisition will be exempt from the IET.[35] The exemption also applies if the acquisition is made in conformity with foreign law as a substitute for the payment of tax.

E. *Export transactions and financing*

In order not to impede the export of United States goods and services, exemptions are provided for securities acquired in connection with export credit transactions.

1. *Intangible personal property*

If foreign stock or debt obligations are acquired arising out of the sale or license of patents, inventions, models, copyrights, secret processes, trademarks, and other intangible personal property, the acquisition is exempt from the IET provided at least 85% of the purchase price or license fee is attributable to the sale or license of property produced or developed in the United States by the seller or licensor.[36]

2. *Tangible personal property*

a. Producing or manufacturing exporter

This exemption is directed toward United States persons who contract to supply an entire plant or installation (turn-key contract) and are required to take part of the contract price in the form of foreign securities. These persons often sub-contract some of the work to non-United States persons.[37] In order not to affect their competitive position, an exemption is provided if: (1) at least 30% of the purchase price, or 60% of the actual value of the foreign stock or debt obligation acquired is attributable to the sale of goods produced in the United States, or to services performed, by the seller, and (2) at least 50% of the purchase price or 100% of the value of the stock or debt acquired is attributable to the sale of United States produced goods or services.[38]

b. Merchant exporters

The 1973 Act enlarges the conditions under which debt obligations acquired by merchant (i.e., non-producing) exporters are exempt from the IET. Debt obligations arising out of the sale or lease of tangible personal property or services (or both) are exempt if at least 85% of the amount of the loan is attributable to the sale or lease of United States made goods or to the performance of services by United States persons. The acquisition of the debt obligations must be reasonably necessary to effectuate the sale or lease of the property or services and the terms of the obligation must be commercially reasonable.[39]

3. *Loans guaranteed by agencies of the United States*

Exempt from the IET are debt obligations arising out of the sale or lease of tangible personal property or the provision of services (or both) by any United States person if payment of the debt obligations is guaranteed or insured by a United States agency (e.g., the Export-Import Bank or the Foreign Credit Insurance Association).

4. *Export related loans (foreign distribution facilities)*

Debt obligations resulting from a loan that the debtor will use for the construction or improvement of facilities maintained by it

27. § 4915 (a) (1). Also exempted are debt obligations which a United States parent receives from its 10% owned foreign subsidiary, if such obligations were received by the subsidiary in the ordinary course of its trade or business as a result of the sale or rental of products manufactured or assembled by it. Id. This rule allows the United States parent to factor the receivables of its foreign subsidiary. Special rules apply to "creeping acquisitions". See § 4915 (a) (2).
28. § 4915 (a) (1).
29. H. R. REP. No. 1046, 88th Cong., 1st Sess. 15 (1963).
30. See Section VII A, infra.
31. See Sections VII B, C, and D, infra.
32. § 4915 (c).
33. § 4922.
34. For the treatment of stock or debt obligations acquired in connection with nationalization, expropriation, seizure, etc. § 4914 (k).
35. § 4914 (b) (3). On a subsequent transfer of such securities, the United States person will be treated as a foreign person. See note 22, supra.
36. § 4914 (c) (3).
37. H. R. REP. No. 1046, 88th Cong., 1st Sess. 17 (1963).
38. § 4914 (c) (2). A similar rule, limited to debt obligations, is applicable to export leases. § 4914 (c) (6).
39. § 4914 (c) (1) (B). See also § 4914 (c) (6) (B). The refunding or the refinancing of the debt obligation may also qualify for the exemption. § 4914 (c) (8).
40. § 4914 (c) (1) (A).

outside the United States and used for the storage, handling, transportation, processing, packaging, or servicing of property, a substantial portion of which will be produced in the United States by the debtor, are exempt from the IET. [41] This provision facilitates the financing of the foreign distribution facilities of United States producer-exporters.

5. *Loss of exemption*

In order to prevent abuse (e.g., by using an export credit transaction as a subterfuge for a financing transaction) the exemptions provided above for export-related transactions will be revoked upon a subsequent transfer of the securities unless the transfer is to certain specified persons (e.g., an agency of the United States or a commercial bank acquiring the securities in the ordinary course of its commercial banking business). [42]

F. *Japanese and Canadian Securities*

The President has the power to exempt the acquisition of foreign securities, whether issued by a foreign government (including local governments) or a corporation organized under its laws, or by any individual resident therein, if the application of the IET would have such consequences for that foreign government as to imperil the stability of the international monetary system. [43] This power is in accordance with the United States' treaty obligation to the International Monetary Fund which requires the United States "... to collaborate with the fund to promote exchange stability..." [44]

The President has exercised the above power with respect to both Japanese and Canadian securities. The acquisition of a new issue of Canadian securities (with the exception of securities issued by a Canadian corporation, partnership, or trust formed for the principal purpose of acquiring stock or debt obligations of a Canadian or other foreign issuer or obligor) is exempt from the IET. [45] The future of this provision is somewhat in doubt as the 1973 Act [46] requires the Secretary of the Treasury to reexamine the exemption for Canadian securities.

Prior to February 3, 1970, the President had also exempted, under certain conditions, debt obligations issued by the Governement of Japan and by certain Japanese corporations. [47] President Nixon revoked this exemption for debt obligations acquired after February 3, 1970, but generally continued it for any stock acquired pursuant to conversion rights. [48]

G. *Commercial bank loans*

Debt obligations acquired by a commercial bank in the making of loans in the ordinary course of its commercial banking business are exempt from the IET. This exemption is subject to modification by the President if he finds that such loans materially impair the effectiveness of the IET

41. § 4914 (c) (4).
42. See generally § 4914 (j). Debt obligations guaranteed by an agency of the United States can be transferred to any person without a loss of the exemption.
43. § 4917 (a).
44. Articles of agreement between the United States of America and other powers respecting the International Monetary Fund, Bretton Woods Agreement, Art. IV, Sec. 4 (a).
45. Exec. Order 11304, 1966-2 CB 482, amending Exec. Order 11175, 1964-2 CB 460.
46. 87 Stat. 12.
47. See Exec. Order 11211, 1965-1 CB 509, as amended by Exec. Order 11368, 1967-2 CB 386. Stock acquired by the conversion of a previously exempt debt obligation was also exempt under certain conditions.
48. See Exec. Order 11506, 1970-1 CB 254.

by substituting for other debt obligations that are subject to the tax. [49] In a series of Executive Orders, [50] the President exercised this authority and narrowed the scope of the exemption. The exemption currently applies, inter alia, to the acquisition of debt obligations by a commercial bank at any of its branches located outside of the United States [51] and to the acquisition of debt obligations arising out of the sale or lease of personal property or services under conditions similar to those discussed in Section IV. E 2 (b), supra. [52]

H. *Foreign property*

1. *Tangible property*

The acquisition of a debt obligation arising out of the sale of tangible property located outside the United States that was held for personal use by the person acquiring the obligation is exempt from the IET. [53]

2. *Real property*

A debt obligation arising out of the sale of real property (other than real property included in (1) above) and located outside the United States is exempt if acquired by the person selling the property. [54]

I. *Foreign stock treated as domestic*

The stock of a foreign corporation (other than a company registered under the Investment Company Act of 1940) is considered to be domestic stock if: (1) as of the corporation's latest record date before July 19, 1963, more than 65% of the stock was held of record by U.S. persons, or (2) the stock's principal market during 1962 was one or more U.S. securities exchanges registered with the Securities and Exchange Commission, and more than 50% of the stock was held of record by U.S. persons. [55] This provision is intended to grant an exemption for stock of a foreign corporation in which there was substantial American ownership at the time the IET first became effective.

J. *Additional exemptions* [56]

Other exemptions apply to loans to foreign corporations to assure sources of raw materials, securities acquired by insurance companies, securities acquired by tax-exempt organizations, student loans, stock purchased to acquire a dwelling, acquisitions by United States persons residing in foreign countries of stock of certain foreign corporations investing exclusively in the United States, sales by underwriters and dealers to foreign persons, acquisitions of debt on the sale or liquidation of foreign subsidiaries or branches, mortgages secured by United States property, and direct investments in certain lending and finance corporations.

VII. ELECTIONS

The IET legislation contains a number of elective provisions that enable a United States person to be treated as a foreign issuer or obligor. In addition, a United States corporation may elect to treat its debt obligations as subject to the IET if acquired by United States persons.

49. § 4931 (a).
50. Exec. Order 11198, 1965-1 CB 513; Exec. Order 11304, 1966-2 CB 482; Exec. Order 11328, 1967-1 CB 316.
51. Exec. Order 11328, 1967-1 CB 316. This exemption is one of the advantages a United States bank obtains by establishing a foreign branch office.
52. See § 4931 (c) (1).
53. § 4914 (b) (14) (A).
54. § 4914 (b) (14) (B).
55. § 4920 (b) (1).
56. See generally §§ 4914, 4919.

A. *Debt obligations treated as subject to the IET*

1. *Prior to 1971*

In 1968 the Department of Commerce introduced its mandatory Foreign Direct Investment Program, administered by the Office of Foreign Direct Investment (OFDI).[57] This program limits foreign direct investment by United States persons and forces many United States corporations to finance their overseas operations by borrowing abroad. This borrowing is often done through a specially created foreign or domestic finance subsidiary.[58]

The use of a finance subsidiary accomplishes two objectives. First, it allows interest to be paid to foreigners free of withholding taxes.[59] This condition is necessary as a practical matter if the issue is to be marketable. Second, the debt obligations issued by a finance subsidiary are subject to the IET if purchased by a United States person.[60] This provision enables the issue to qualify as long-term borrowing for purposes of the OFDI, a classification which is generally advantageous to the United States parent.[61]

2. *1971 and 1973 amendments*

The incorporation and use of a finance subsidiary requires careful tax planning since the required objectives are achieved only by the proper utilization of both domestic tax law and tax treaties. Finance subsidiaries are also costly in terms of the administrative effort needed to properly police them. In an attempt to eliminate these subsidiaries and to simplify foreign financing, the 1971 Interest Equalization Tax Extension Act[62] (1971 Act) made two changes. First, it allowed a United States corporation (or partnership) to treat its debt obligations as those of a foreign obligor, and therefore subject to the IET if acquired by United States persons.[63] Second, the interest payments on these debt obligations are exempt from the United States withholding tax provided the debt has a maturity period of less than 15 years and was originally purchased by underwriters with a view to distribution through resale.[64]

Although the 1971 Act allowed a corporation to both issue debt obligations that complied with the OFDI regulations and to make interest payments on these obligations free of withholding tax, it still failed to significantly reduce the use of finance subsidiaries. This failure stemmed from a difference between the estate tax treatment of debt obligations issued by a finance subsidiary and those issued directly by the parent. A nonresident alien is not subject to the United States estate tax with respect to debt obligations issued by a finance subsidiary, regardless of where the subsidiary is incorporated.[65] However, debt obligations issued by a United States corporation that elected to treat such obligations as a foreign issue for purposes of the IET were, in most cases, subject to the estate tax.[66] Because of this potential tax liability, United States corporations feared they could not market debt which they themselves had issued, and thus they continued to utilize finance subsidiaries.

The 1973 Act eliminates the disparity in estate tax treatment by providing an exemption from the estate tax for debt obligations that a United States corporation elects to treat as subject to the IET.[67] This exemption, together with the 1971 provisions, should now allow a corporation to directly issue its own debt and achieve the same advantages as if it had used a finance subsidiary.

B. *Foreign office of a United States securities dealer*

A United States corporation (or partnership) that is a dealer[68] in securities may elect to treat its foreign branch office as a foreign person.[69] This election enables the foreign branch to buy foreign securities free of the IET.

C. *Foreign lending and finance business*

A United States corporation (together with its subsidiaries) that is primarily engaged in the lending or finance business through foreign offices and that holds itself out as lending money to the public generally may elect to be treated as a foreign corporation.[70] This election places finance companies on the same competitive footing as the foreign branches of United States banks.

Prior to the 1973 Act, a corporation was considered to be primarily engaged in the lending or finance business only if it made loans whose remaining maturity period were less than 48 months. In order to re-

57. See generally Foreign Direct Investment Regulations, 15 C. F. R. § 1000 et seq.

58. Finance subsidiaries may also be used to raise money in the Eurodollar market for use by the parent in the United States. If the money raised by the finance subsidiary is to be used in the United States, the subsidiary is usually incorporated abroad. Because of favorable treaty provisions, foreign finance subsidiaries are often incorporated in Luxembourg, the Netherlands or the Netherlands Antilles. If the money raised by the finance subsidiary is to be used abroad the subsidiary is usually incorporated in the United States. However, if the money is to be used in a less developed country, the subsidiary is usually incorporated abroad. For a detailed analysis of the organization and use of finance subsidiaries, see Boffa, International Finance Subsidiaries, 215-2nd T.M.; see also Forsyth and Singer, The IET Extension Act: Simplification of foreign financing for United States companies, 35 J. TAX. 80 (1971).

59. In the case of domestic finance subsidiaries this result is achieved because of the "80-20" rule. Under domestic tax law, interest paid by a domestic corporation is exempt from the United States withholding tax if less than 20% of the corporation's gross income comes from United States sources. § 861 (a) (1). Since domestic finance subsidiaries (also known as "80-20" subsidiaries) invest most of their funds abroad they satisfy the "80-20" test. Foreign finance subsidiaries are incorporated in those countries where tax treaties provide for the payment of interest free of withholding taxes.

60. Domestic finance subsidiaries are normally formed or availed of for the principal purpose of obtaining funds for a foreign issuer or obligor. The securities issued by the subsidiary are therefore subject to the IET if acquired by United States persons. See text accompanying note 5 supra. Securities issued by a foreign finance subsidiary are subject to the IET under the normal principles.

61. See 16 C. F. R. § 1000.324.

62. 85 Stat. 13.

63. § 4912 (c). The tax on the acquisition of such obligations is levied at the rate applicable to the acquisition of stock issues (currently 11.25%).

64. § 861 (a) (1) (G).

65. Foreign debt obligations are not included in a nonresident alien's gross estate. §§ 2103 and 2104. Debt obligations issued by domestic corporations are not included in a nonresident alien's gross estate if less than 20% of the corporation's gross income comes from United States sources. Since domestic finance subsidiaries are structured so that they comply with the "80-20" test (see note 59, supra), their debt obligations are exempt from the estate tax.

66. It would be unusual if the corporation could satisfy the "80-20" test.

67. § 2104 (c).

68. The term "dealer" means any person who is a member of a national securities association registered with the Securities and Exchange Commission and who is regularly engaged, as a merchant, in purchasing stock or debt obligations and selling them to customers with a view to the gains and profits which may be derived therefrom. § 4919 (c) (2).

69. § 4902 (a) (5).

70. § 4920 (a) (3) (C).

flect current trade practice, the 1973 Act increases this period to 60 months. [71]

D. *Commercial financing branches*
The foreign branch of a United States corporation that is primarily engaged in the trade or business of acquiring debt obligations arising out of the sale of tangible personal property produced, manufactured, or assembled by affiliated corporations may be treated as a foreign corporation under certain conditions. [72]

E. *Other elections*
Other elections apply to a United States registered management company [73], insurance companies, [74] lending or financing corporations, [75] and foreign underwriters. [76]

71. § 4920 (a) (3A) (A).
72. § 4920 (a) (5A).
73. See § 4920 (a) (3) (B).
74. See § 4914 (e).
75. §§ 4920 (a) (3B) and 4915 (c) (3).
76. § 4920 (c).

SIJBREN CNOSSEN [1]:

SALES TAXATION IN INDONESIA

It is generally held that the tax system of a developing country should include a general sales tax, because of its high revenue potential at tolerable rates, restraining influence on household consumption and thus favorable effects on savings, relative simplicity, and administrative feasibility compared to an income tax. It is argued that the tax burden distribution of a sales tax can be improved through the exemption of basic necessities and the application of differential rates. For these and other reasons, Indonesia introduced a general sales tax in 1950. As revised in 1951, 1960 and 1968, the tax is a single stage levy imposed on importation and manufacture. A number of services are also taxable, but exports are free of tax. The general rate of tax is 10 per cent, but a 5 percent rate applies to a wide range of raw materials and intermediate goods, as well as to services; some luxury goods are taxed at 20 per cent. In fiscal year 1971, the sales tax contributed 12 per cent of the central government's total tax receipts, more than half of which was collected on imports. This article explores the general design of the tax, examines some structural problems, and briefly considers some of the chief alternatives.

GENERAL DESIGN OF THE TAX [2]

Taxable activities
The Indonesian Sales Tax Act charges three kinds of activities with tax: (a) the delivery of goods by manufacturers; (b) services rendered by specifically enumerated entrepreneurs; and (c) the importation of goods by entrepreneurs. An entrepreneur, including a manufacturer, is defined as "any person who, within Indonesia, independently carries on a business or profession". The qualifying term "independently" implies that employees are excluded.
Government activities are subject to the sales tax, unless they concern a form of activity which because of its nature can be performed by government only. Self-deliveries are not taxable. Manufacturing encompasses a wide range of activities — the Act includes production, manufacture, processing, growing or preparing of goods — whose common characteristic is change in the physical form of goods. Thus, in addition to industrial manufactures, agricultural and mining products are also included, but trading per se is not. Processing is covered only if the nature of the goods has changed; this means that activities involving the packing, sorting, mixing, and marking of goods are not taxable, unless the manufacturer himself performs them. Whether a change in the nature of a good has taken place depends largely on circumstances; restoring used and damaged goods to their original condition is not considered a change in nature, unless such goods were completely obsolete before the repair. Manufacturers and importers are subject to sales tax only if they deliver or import goods, defined as corporeal mov-

1. The author is on the staff of the International Monetary Fund, but this article represents his personal views only.
2. For a structural analysis and legal commentary, see Sijbren Cnossen, *The Indonesian Sales Tax: Status and Structure, Technical Features* (Kluwer: Deventer, The Netherlands, 1973).