MEMORANDUM ON FOREIGN BUYING CONFIDENTIAL

Except for the nationalistic and isolationistic implications that it might carry, and that element has to be carefully thought out before the step is taken, there are perfectly good reasons why some regulatory steps should be taken to control the trading by foreigners in the American security market. One reason is that the flow of such capital is under only limited control by the SEC, and, hence, an unfair advantage is given to the foreigner. But, the most important reason is the following:

The resident in America who pays taxes is contributing to the economic environment that makes possible his dividends and capital appreciation; such taxes supposedly are commensurate to what that environment is worth to him, otherwise he would move out of that environment. That is the theory of taxation. However, the foreigner who buys securities in this country is subject only to a normal tax, and that only on dividends. He is not subject to other taxation. Therefore, whether his income from dividends is $500 or $100,000, his tax brackets do not rise. Since there is no detention of the tax at the source, it is not certain that, whenever the stock is held in the name of a dummy, there is no evasion of taxation altogether. Nor does the foreigner pay a capital tax profit. It is true the foreigner, depending upon the country in which he lives, may pay normal and surtax there, but, also, he may not. But, whether or not/he pays such taxes abroad, he is, as far as this country is concerned, getting out of it something on which he does not pay commensurately to what the American pays. To that extent, his capital does not contribute to the up-keep of the government as full a share as that of the resident in America contributes. If, for example, he is incorporated in a country which has lax tax laws, he gets not only a relative, but an absolute advantage over the American citizen.

In order to eliminate this advantage which he may enjoy; more generally, in order to eradicate tax inequalities, and in order that the American government may not lose sources of revenue to which it is properly entitled, because, they come from profits on American industry made possible by this government, the following is tentatively suggested:

A. In connection with any securities purchased by foreigners, or for accounts of foreigners, there should be:

1. Put up a deposit to protect the United States from possible losses in taxes, except for cases exempt by the Internal Revenue Department. The foreigner will be requested to file an income tax return showing all his sources of revenue derived in the United States, less legitimate expenses, his net income to be taxable in the same way as that of a permanent resident of the United States.

2. Taxes on dividends on stocks, the beneficial owner of which is a foreign person, should be retained at the source.

3. Whenever a transfer of securities is made, the company should be informed as to the name and address, nationality and residence of the beneficial owner.

4. Whenever brokers or dealers buy securities and such securities are left in a street name and are not transferred, the broker or dealer who purchased the securities should inform the company as to the address, the resident, etc., of the beneficial owner.

5. If any broker, dealer or bank ships securities abroad in any name other than the name of the beneficiary, the company should be informed of the certificate, number, the number of shares, the nationality and residence of the beneficial owner.

If transferred in a foreign name, the company will, of course, be informed by the broker, bank, etc.

Copy of such information to go to the Internal Revenue Department, which will require a tax deposit when the purchase is made by a resident abroad.

It is not impossible that a kind of bootleg market may develop; that the securities will be first bought in the name of an American, and an American non-broker or non-dealer will ship them abroad. Such type of evasion will have to be watched.

The above measures will greatly reduce, if not prevent altogether, purchases of American securities, which may, of course, in certain cases, work hardship, and which, in exceptional cases, may be exempt from such regulations by the Internal Revenue Department, which would keep control over the movement of securities. One of the hardships will be that it will prevent arbitrage. This is nothing particular to worry about, however, as the world can get along without arbitrage. However, as long as arbitrage transactions are conducted without the shipment of securities abroad, it may be possible, by proper affidavits filed by foreigners, to exempt them, if the broker who conducts the arbitrage himself puts up a certain reserve to provide for his own taxes. That may be a little difficult, because it will require the apportionment of the profit and loss between the two markets, and, also, the opening of the books to the United States Internal Revenue inspector. But, as I said, arbitrage is important only if there is an active interchange of securities between two capital markets, which may not be the case. If securities are shipped abroad, then they are subject to rules A, above.

B. The next question that comes up is the question of how to repatriate the American security already sold to foreigners, held either in this country or abroad.

The United States government may make an announcement that, within six months, there will be a tax imposed on securities sold by foreigners or for the account of foreigners, other than those exempt by the Internal Revenue Department for good reasons. The flat rate of such a tax can be justified by the fact that the foreigners who purchased securities earlier do not pay capital profit taxes, which Americans must do. Because that capital profit tends to increase with time, there may be a graduating scale; say, starting out after the lapse of six months grace, with 10%, and rising to, say, 25% in the next two years. That will mean that United States Steel stock held by foreigners after six months will have a value, if sold here at any time, of at least 10% less than the American, 10% going to the government as a settlement for possible tax evasions. The tendency will be to sell out securities before six months elapse, so as to get their full value. Such securities as will be continued to be held abroad, in spite of the tax when sold, will be, of course, subject to a tax on dividends retained at the source, if and when such stocks pay dividends. Such tax, furthermore, could be made flexible; for example, increased if stock is held for several years with a view of inducing early resale in American markets.

I purposely suggest a period of two years, because I think there is a pretty reasonable chance that, for the next two years, market conditions will continue generally good, so that such selling will take place at a time when there will be good domestic buying. Usually repatriation is done at the wrong time, that is, foreigners sell securities at the time Americans are selling them. Hence, if we decide at all upon any repatriation, it should be done as early as possible, and this is one of the ways to bring this about.

In order that there should be no evasion, the broker, or bank, etc., when selling securities for a customer, should have to produce an affidavit showing the American permanent residence and the source of acquisition which will exempt the seller from paying the foreign tax. Of course, there will always be possible evasion, the foreigner selling to an American dummy for his own account, the dummy selling for his own account, and then transferring the full amount to the foreigner. But such evasions are no different than any other tax evasions, and tax inspectors will simply have to watch them, as they watch other evasions.

Among the other things that will strengthen this rule would be that no dividends should be paid by the company, except on an affidavit that they go to an American resident, or, if to a foreigner, with normal tax deducted at the source, plus such attachments for the benefit of the government, as the case may require. If, because of the difficulty of policing foreign taxpayers, the tax on dividend deduction at the source is increased, on the justification of possible evasions of surtaxes, it will tend to discourage foreign buying.

This thing will involve quite a complicated control machinery, and it will obviously reduce the freedom of international capital movement, and is not entirely in accord with the enlightened international policies of the New Deal. However, the situation is so unusual --- A world war may break out at any time, in which the experience of the last world war may be repeated, where, in order to finance the war, European countries will dump their securities in the United States in a market now, from a technical point, weakened by the capital profit tax, by Section 16, and by many other factors. As a matter of fact, that is what already happened in the case of Italy, which mobilized its foreign securities during the Ethiopian war and presumably sold many of them, and I understand there is a movement on foot in Germany to do likewise. Consequently, the problem cannot be ignored, difficult as it is, and, although it may have certain undesirable aspects, will require very careful and intelligent handling. But, whatever we do, it is important that measures, if any are decided upon, that would aim at the liquidation of securities by foreigners, should not be aimed to become effective at a time when American themselves would sell; that is, such measures should be undertaken while our market conditions are still generally strong.

ADDENDUM

Another way would be that every foreign buyer of American securities, or resident abroad, could not get the security out of the country, but would have to nominate an agent to represent him, who would hold the security for him. The security will be held here until it is sold and the taxes paid. The agent holding the collateral will be responsible for the payment of the proper taxes on dividends, and capital tax. A foreigner or foreign resident could have but one nominee.

It goes without saying that any radical steps of that kind will have to be discussed with the State Department here, and the Treasury Department in Great Britain.