vestment activity in the United States or because they have granted a discretionary investment power to a U.S. banker, broker, or adviser. No legislative change is necessary to provide that the volume of transactions is not material in determining whether an investor is engaged in trade or business in the United States as this is the rule under present law.

Real estate income and mineral royalties

Under present law it is not clear whether a nonresident alien (or foreign corporation) is engaged in trade or business in the United States by reason of the mere ownership of unimproved real property or real property subject to a strict net lease, or by reason of an agent's activities in connection with the selection of real estate investments in the United States.

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If because of such activity a nonresident alien is considered as not engaged in trade or business he becomes subject to withholding tax on his gross rents. Since the consequent tax could exceed his net income, the taxation on a gross basis of income from real property should not be continued where taxation on a net basis at graduated U.S. rates would be more appropriate.

Therefore, a nonresident alien or foreign corporation should be given an election to compute their income from real property (including income from minerals and other natural resources) on a net income basis and at regular U.S. rates as if they were engaged in trade or business in the United States. Such an election is comparable to the one now appearing in many treaties to which the Unite dStates is a party. Such an election would not effect the method of taxation applied to his other income.

3. Capital gains: Eliminate the provision taxing capital gains realized by a nonresident alien when he is physically present in the United States, and extend from 90 to 183 days the period of presence in the United States during the year which makes nonresident aliens taxable on all their capital gains.

The underlying policy of U.S. taxation of nonresident alien individuals has been to exempt capital gains realized from sources in this country. This policy has been proper both from a tax policy standpoint and from the viewpoint of our balance of payments. However, existing law has two limitations: U.S. capital gains realized by a nonresident alien while he is physically present in the United States, or realized during a year in which he is present in the United States for 90 days or more, are subject to a U.S. tax of 30 percent.

The limitations now contained in our law, especially the physical presence test, contain illogical elements and are likely to have a negative impact on foreigners who are weighing the advantages and disadvantages of investing in the United States. The physical presence test was added to the law after World War II when many nonresident alien traders were frequently present in this country. Since this is no longer true, and moreover, since the tax may be readily avoided by passing title to the property outside the United States, the provision now serves little purpose. However, it does pose a threat to the foreign investor which may deter him from investing in this country and therefore should be eliminated.

The limitation relating to presence in the United States for 90 days or more in a particular year should be retained, but the period should be lengthened to 183 days. This extension will remove a minor deterrent to travel in the United States and help mitigate the harsh consequences which may arise under the existing rule if a nonresident alien realized capital gains at the beginning of a taxable year during which he later spends 90 days or more in the United States.

4. Personal holding company and "second dividend" taxes: (a) Exempt foreign corporations owned entirely by nonresident alien individuals, whether or not doing business in the United States, from the personal holding company tax; (b) modify the application of the "second dividend tax" of section 861(a)(2)(B) so that it only applies to the dividends of foreign corporations doing business in the United States which have over 50 percent U.S. source income.

Under present law any foreign corporation with U.S. investment income, whether or not doing business here, may be a personal holding company unless it is owned entirely by nonresident aliens, and unless its gross income from U.S. sources is less than 50 percent of its gross income from all sources.

The personal holding company tax should not apply to foreign corporations owned entirely by nonresident aliens. The only reason for applying our personal holding company tax to foreign corporations owned by nonresident aliens has been to prevent the accumulation of income in holding companies organized to avoid the graduated rates. With the elimination of graduated rates as suggested in recommendation 1 (and the revision of the second dividend tax, discussed below), U.S. investment income in the hands of foreign corporations will have borne the U.S. taxes properly applicable to it and accumulation of such income will not result in the avoidance of U.S. taxes imposed on the company's shareholders. Hence, there is no longer any reason to continue to apply the personal holding company tax to these corporations.

With respect to the "second dividend tax," section 861(a)(2)(B) now provides that if a corporation derives 50 percent or more of its gross income for the preceding 3-year period from the United States, its dividends shall be treated as U.S. source income to the extent the dividends are attributable to income from the United States. As a result such dividends are subject to U.S. tax when received by a nonresident alien. This tax is often referred to as the "second dividend tax." However, under section 1441(c)(1) a foreign corporation is not required to withhold tax on its dividends unless it is engaged in business in the United States and, in addition, more than 85 percent of its gross income is derived from U.S. sources.

It is now proposed to levy this second dividend tax only where the foreign corporation does business in the United States, and 80 percent or more of its gross income (other than dividends and capital gains on stock) is derived from U.S. sources. Where a foreign corporation is not doing business in the United States, it will pay U.S. withholding taxes on all investment income and other fixed or determinable gains and profits derived from the United States, and since that is all the tax its foreign shareholders would owe if they received the income directly, no second tax seems warranted.

With the adoption of the rule that the income from the U.S. stock investments of for-