I. INTRODUCTION

The purpose of this memorandum is to express our views upon one particular aspect of the proposed legislation contained in H.R. 5916. Before doing that, we would like to indicate that we believe the basic legislation contained therein to be good for the country and practicable from an operational and administrative standpoint. Therefore, in general, we are in favor of the bill. However, there is one specific portion thereof which we believe runs counter to the fundamental purpose of the bill and would cause unwarranted disruption of traditional, legitimate business patterns. The particular provision to which we refer is a proposed amendment to section 882 of the Internal Revenue Code of 1954 and is contained in section 4(b) of H.R. 5916. The proposed amendment would (1) eliminate the the intercorporate dividends received deduction in the case of all resident foreign corporations and (2) exempt such corporations from tax on capital gains realized in connection with their U.S. stock investments.

Dividends received would thus become subject to the 30-percent statutory withholding rate or any lesser treaty rate applicable to such income, rather than the previous 7.2-percent maximum rate of tax thereon. Essentially, the proposed amendment presents the following three problems: (1) it applies to a much wider class of taxpayers than is necessary to curb the specific abuse which led to its proposal; (2) it would, in its present form, disrupt and foreclose a traditional and legitimate means that a number of foreign corporations have historically used to conduct business in this country; and (3) unless modified, it might very well have the effect of discouraging existing and potential long-term investment here by large foreign corporations despite the fact that the avowed purpose of H.R. 5916 is to stimulate and foster foreign investment in the United States as part of a program to improve our balance of payments.

II. DISCUSSION

A. The purpose of the proposed amendment

The purpose of the proposed amendment, as indicated in the Treasury release dated March 8, 1965, accompanying H.R. 5916, would appear to be twofold. (1) First of all, the amendment is designed to curb a rather narrow and limited abuse which occurs when certain foreign corporations, that are essentially passive investment or holding companies, engage in trade or business in the United States in some minor way (such as through the ownership of several parcels of real estate) and thereby qualify for the 85-percent intercorporate dividends received deduction with respect to their U.S. stock investments. The proposed amendment, however, goes far beyond this stated purpose. Because of its generalized applicability, the amendment would deny the intercorporate dividends received deduction even to foreign corporations which are actively engaged in substantial, active business operations in this country. (2) In the second place, the proposed amendment is designed to segregate business income from investment income in connection with the taxation of foreign persons. The proposed amendment is defective in this respect, for in the case of a number of foreign corporations it would classify as investment income what is, in essence, business income. This occurs because the proposed amendment fails to treat as business income the dividends received by a resident foreign corporation from affiliated domestic subsidiaries. A foreign corporation which conducts business here through a branch may also, for a variety of reasons, engage in one or more additional businesses in this country through ownership of affiliated domestic subsidiaries. The dividend income received from such affiliated companies is actually business income.

B. The result of such a broad legislative approach would be to foreclose to resident foreign corporations a traditional and legitimate means of conducting business in this country

While this statement is not being made on behalf of any particular foreign corporation, it appears to us on the basis of our own experience that there are a number of concerns that (1) would be adversely affected by the proposed amendment as presently drafted and (2) would have to alter substantially the nature of their operations in this country as a result of the loss of the intercorporate dividend deduction. It is true that, for the most part, foreign corporations conducting business in the United States will do so through a domestic subsidiary in order to avoid complicated problems of allocation of income. However, there is a large number of foreign corporations which, for historical or other reasons, conduct