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JUNE 24, 1965.

MEMORANDUM REGARDING THE DEFINITION OF NONBUSINESS
INCOME UNDER SECTION 4 OF H.R. 5916

In connection with the administration's program to improve the U.S. balance of payments, the Fowler Committee Report of April 27, 1964, proposed a number of related changes in U.S. tax laws governing the receipt of U.S. source income by foreign investors. The recommendations of the Fowler Committee Report have been further developed by the Treasury and are incorporated in H.R. 5916, which is designed, in the words of the Treasury, "to stimulate foreign investment in the United States by removing existing tax barriers to such investment." The principal thrust of this legislation is toward a less complicated and more favorable tax treatment of portfolio investments by foreigners in U.S. corporate securities.

Virtually everyone considers interest income as a form of investment income, and it has been so considered by the Treasury and Congress in the past as, for example, in the definitions of personal holding company income (I.R.C. sec. 543) and subpart F income (I.R.C. secs. 952 and 954). This same policy is employed in section 3 of H.R. 5916, which defines the nonbusiness income of nonresident alien individuals in a manner that would include income from debt securities. (The Treasury press release of Mar. 8, 1965, describing H.R. 5916, refers on p. 2 to foreigners' nonbusiness income, "such as dividends and interest.")

It is with surprise, therefore, that one finds in section 4 of H.R. 5916 that the proposed definition of nonbusiness income of a foreign corporation engaged in trade or business in the United States does not include interest from debt securities. It is not clear to us what policy would be furthered by not including income from debt obligations in the definition of nonbusiness income in this section. If it has been omitted out of a concern over possible tax avoidance possibilities, we believe that any such possibilities should be attacked directly and not by excluding interest income.

Section 4 of H.R. 5916 proposes to amend section 882 of the Internal Revenue Code, relating to the income of foreign corporations, to define "business income" and "nonbusiness income." The characterization of income under these definitions controls the U.S. income tax consequences for foreign corporations in several situations.¹ Nonbusiness income is limited in the proposed definition under section 882(a) (3) and (4) to dividends and capital gains from the sale of corporate stock, and amounts described in section 631 (b) and (c).

Foreign corporate investors, including foreign-based investment companies investing in U.S. securities, frequently include bonds, debentures, and other debt securities of U.S. issuers in their portfolios. We believe that the failure to grant favorable tax treatment for income from such investments on a par with stock investments

¹ The definition of nonbusiness income will be significant in the following principal cases: (1) All foreign corporations (whether or not such corporations are engaged in trade or business in the U.S.) will be subject to a flat 30 percent withholding tax rate on their nonbusiness income; (2) the U.S. second dividend tax under I.R.C. sec. 861(a)(2)(B) will not apply to nonbusiness income.