

results in an unwarranted limitation on the flexibility of foreign-owned portfolios of U.S. securities. It would, for example, discourage the investment policy of a number of existing foreign investment companies and mutual funds that now invest exclusively in U.S. stocks and bonds.

In some situations, the discrimination against income from debt securities will result in unnecessarily complex arrangements for foreign portfolios containing investments in U.S. securities. This arises, for example, in the situation in which it is proposed to eliminate the "second dividend" tax of section 861(a)(2)(B) so that such tax will hereafter apply only to dividends paid by foreign corporations that are engaged in business in the United States and which have 80 percent or more of their business income from U.S. sources. (See sec. 2 of H.R. 5916 amending I.R.C. sec. 861(a)(2)(B).) As indicated by the Treasury explanation, if a foreign corporation is an investment company investing in U.S. securities and receiving as its total income only dividend and interest income and capital gains from the sale of securities from U.S. sources, the second dividend tax will be applicable to the corporation's distribution to its stockholders of dividends representing income received in the form of interest or capital gains from the sale or exchange of United States debt securities, i.e., its U.S. business income, unless the foreign corporation has more than 20 percent of its total business income (excluding for this computation all nonbusiness income from all sources) from sources outside of the United States. This imposes a mechanical limitation on foreign investment companies, particularly those investing exclusively in U.S. securities, that seems unwarranted in the light of the purposes of the act.

Unless section 882 is amended, as suggested above, after enactment of H.R. 5916 the present 48-percent U.S. corporate tax rate will continue to be imposed on interest income from U.S. sources where a foreign corporation is engaged in trade or business in the United States.² A combination of the U.S. corporate tax rate, in addition to the potential second dividend withholding tax, would continue to be an impediment to investment in U.S. debt securities for portfolios of foreign corporate investors. Notwithstanding the attempted clarification of H.R. 5916 of when a foreign corporation is engaged in trade or business in the United States, the answer to this question will not always be clear and foreign investors and their tax advisors will not be certain of the impact of U.S. taxes imposed on the basis of that determination. It seems to be doubtful policy to have such uncertainty extend to the U.S. tax treatment of interest income.

CLEARY, GOTTlieb, STEEN & HAMILTON.

² The present 30-percent withholding rate (or a lower tax treaty rate) would remain in effect in the case of corporations not engaged in trade or business in the United States.