

One further aspect of the bill may well serve to discourage investment in the United States. Under present law, it is possible to give fairly definite advice to a foreign corporation or partnership wishing to establish a branch in this country as to what part of its income will be treated as income from sources within the United States and subject to tax here. H.R. 11297 would abandon the use of these clearly defined "source" rules and instead subject to U.S. tax all income that is "effectively connected" with a U.S. branch operation. The "effectively connected" concept is vague and ill defined. To the extent that the bill substitutes an unclear standard of taxability for a clear one, making it more difficult for a foreign investor to determine what U.S. tax he will pay, it will, in the committee's opinion, serve to discourage investment in the United States.

Our detailed comments are submitted under six principal headings, as follows:

SOURCE OF INCOME

Section 2(a). Interest

The general effect of this provision is to extend the present exclusion of interest on bank deposits from U.S.-source income to interest paid by savings and loan associations and to interest paid on amounts held by an insurance company under an agreement to pay interest thereon. However, with one minor exception described below, the present exclusion of bank deposit interest from U.S.-source income as well as the proposed extension will terminate on December 31, 1970. Thus, all such interest paid or credited after December 31, 1970, will be subjected to a 30-percent withholding rate (or to any lower treaty withholding rate). It is believed that such change, even though deferred to 1970, will tend to discourage new deposits of substantial sums with U.S. banks, as well as encouraging the withdrawal of substantial deposits presently held by foreigners.

Section 2(a) of the bill adds a new subparagraph to the code excluding from "U.S. source income" interest paid on foreign currency deposits in foreign branches of U.S. banks, a change which is necessary because of the proposed termination of the present exclusion of bank interest from U.S. source income. This provision is desirable but should be extended to cover all interest paid by foreign branches of U.S. banks. If interest on dollar deposits in foreign branches of U.S. banks is subject to U.S. withholding taxes, such branches will be noncompetitive with local foreign banks. The resulting reduction in their earnings may tend to worsen the U.S. balance of payments. Should the above restriction induce the incorporation of their foreign branches by U.S. banks, the balance of payments may be further worsened by the accumulation of their earnings free of U.S. tax in such incorporated branches.

Section 2(b). Dividends from foreign corporations

This section modifies present code section 861(a)(2)(B) to provide that dividends from a foreign corporation are to be considered income from U.S. sources only if 80 percent of the corporation's gross income for the preceding 3-year period consisted of income effectively connected with the conduct of a trade or business within the United States. This change represents a marked liberalization of the present requirements for exclusion of dividends of foreign corporations from