

rities or commodities transactions is not material in the determination of whether an investor is engaged in trade or business within the United States.

Income "effectively connected" with a U.S. trade or business

The bill actually utilizes the "effectively connected" concept for two purposes. First, the concept is used to determine whether dividends, interest, royalties, and other ordinarily "passive" types of income which are admittedly subject to U.S. tax are part of the income of a U.S. trade or business and properly subject to full rates of U.S. income tax or subject only to normally lower withholding tax rates. This use of the "effectively connected" concept parallels its use in the recent protocol to the United States-German Income Tax Convention and in the OECD Draft Double Taxation Convention. To this extent the use of the concept is proper and desirable, even recognizing the areas of question which underlie its interpretation. However, the bill then uses the "effectively connected" concept in a way in which it is not used in U.S. tax conventions or in the OECD draft. It is this second use of the concept which the committee believes represents a serious and undesirable departure from present law.

Under present law if a foreign corporation or nonresident alien is engaged in trade or business in the United States, then U.S. tax is imposed on the industrial and commercial income¹ of that trade or business to the extent that it is "from sources within the United States" (IRC secs. 872(a), 882(b)). The code and regulations contain fairly precise definitions of what is and is not income from sources within the United States and the case and other authority is now sufficiently clear so that definite answers can be given to the bulk of source of income questions arising in connection with industrial and commercial income. However, the bill would discard all of these established and well-understood rules and would treat as income of the foreign person's U.S. trade or business *all income* "effectively connected" with that trade or business without reference to its "source."

Proposed section 864(c) would provide a series of fairly amorphous "factors" which are to be "taken into account" in determining whether income is "effectively connected" with a U.S. trade or business. These "factors" provide no answers to the following everyday questions that will necessarily arise in applying the "effectively connected" concept. If goods are processed here and then shipped to a foreign country where they are sold through stores, with the benefit of extensive advertising, what part of the profit on sale is "effectively connected" with the trade or business carried on in the United States? What portion of the income from a sale of goods is effectively connected with the U.S. trade or business if goods are processed both here and abroad and then sold abroad? Suppose that the foreign corporation holds foreign patents, without which goods manufactured here could not be sold abroad. Does this affect the amount of income "effectively connected" with the U.S. trade or business? Suppose that a foreign corporation managed in this country operates oilfields throughout the world. What portion of its income is "effectively connected" with its U.S. trade or business?

¹ The code does not use the term "industrial or commercial income." The term as used here provides a convenient description of the types of income which will be affected by this change in present law.