

BAKER, MCKENZIE & HIGHTOWER,
ATTORNEYS AT LAW,
Washington, D.C., February 11, 1966.

Re H.R. 11297—"Effectively connected" and certain partnerships.
Dr. LAURENCE N. WOODWORTH,
*Chief of Staff, Joint Committee on Internal Revenue Taxation,
Washington, D.C.*

DEAR DR. WOODWORTH: This is to call your attention to a possible unintended repeal of a basic partnership rule by the "effectively connected" income concept proposed by H.R. 11297.

The problem involves U.S. partnerships with branch offices in various foreign countries. A number of large accounting and law partnerships exemplify the situation. The partners in many of the foreign offices of these partnerships are nonresident aliens. As you know, under the provisions of section 704(a) and section 702(a)(8), and the regulations thereunder, the partners by the terms of their partnership agreement can provide that the distributive share of the nonresident alien partners is to be derived from the income earned in their respective foreign countries. The effect of such provision, of course, is to establish that such partnership income does not have its source in the United States and accordingly is not subject to taxation by the United States. This well-settled rule of partnership law is in accord with the basic objectives of subchapter K.

In its present form, in the absence of a committee report explanation, it is possible to construe the definition of "effectively connected" income contained in proposed section 864(c) in H.R. 11297 as abrogating the foregoing rule of subchapter K. The problem is created by the following language of proposed section 864(c):

"For purposes of this title, factors to be taken into account to determine whether gains, profits, and income or loss shall be treated as 'effectively connected' with the conduct of a trade or business in the United States by a non-resident alien individual or foreign corporation include whether—

* * * * *

(2) the gains, profits, and income or loss are accounted for through such trade or business * * *."

I am aware that at least one partnership maintains a centralized system of bookkeeping whereby the income and expenditures of its various foreign branches are recorded and the overall operation of the firm coordinated. The broad language of the statute, i.e., whether income is "accounted for through such trade or business," could conceivably result in subjecting the foreign source income of the nonresident alien partners of such partnership to Federal income taxation. Clearly, such a result does not appear to be the objective of H.R. 11297. And, of course, the statute merely lists a number of factors which are to be taken into account and does not state that the existence of one or all of these factors necessarily leads to the conclusion that the income has been effectively connected with a U.S. trade or business. Nevertheless, there is sufficient basis in the statute to warrant serious concern on the part of partners who might be affected by such a possible construction of the law. It is the purpose of this letter to urge that the committee make it clear either in the