

NEW TAX CONCEPT—"EFFECTIVELY CONNECTED"

One of the recommendations of the Fowler Committee was that foreign investors who are engaged in trade or business in the United States should nevertheless be entitled to have their U.S.-source-investment income taxed at the same rates as persons who were not so engaged. In H.R. 11297, there are provisions to segregate and separately tax investment income and noninvestment income. However, the bill also contains a provision under which the tax on nonresident aliens and foreign corporations will be extended to sources outside the United States if it is "effectively connected" with their U.S. trade or business.

The principle of taxing foreign corporations only on their U.S.-source income is so fundamental in existing law that the proposed change requires many collateral amendments of the code. While the bill makes amendments to the provisions relating to foreign tax credits and dividends-received deductions, these changes are so complex that extended study would be required to determine whether these changes are all that are necessary and to evaluate the importance of the cases in which there may not be complete alleviation of double taxation as a result of the changes.

The introduction of this concept could result in a radical change in the patterns of U.S. taxation of foreign corporations owned by U.S. corporations and individuals. The language which is contained in the proposed revision of the bill could be interpreted to enable the imposition of U.S. income taxes on foreign subsidiaries of U.S. corporations which have relatively minor activities on the part of officers of the foreign subsidiary or officers of the parent corporation on behalf of the subsidiary. Such a change is undesirable and seems unnecessary in light of the major review and overhaul of the taxation of such corporations undertaken in the Revenue Act of 1962.

The introduction of such a novel concept as taxing foreign persons on their income from sources without the United States seems inappropriate in this legislation because it is not connected with the primary purpose of the bill.

Approximately three-quarters of our income tax treaties provide that where a foreign corporation has a permanent establishment in the United States such permanent establishment is subject to tax only on its U.S.-source income attributable to the permanent establishment.

The term "effectively connected" is not defined in the bill, but instead, proposed section 864(c) merely cites three factors which should be taken into account in determining whether gains, profits, and income or loss shall be treated as "effectively connected" with the conduct of a trade or business within the United States.

It is considered that the lack of a clear definition of "effectively connected" would tend to discourage U.S. investment. Nonresident aliens and foreign corporations in trade or business in the United States could not be sure whether they would be entitled to the investment rate of U.S. taxation on their U.S. investment income or whether their foreign source income would also become subject to U.S. tax.