

Our prior report on H.R. 11297 objected to these proposals on the ground that they probably would induce nonresident aliens to withdraw their deposits and to dispose of bonds issued by U.S. persons.

Section 8 of H.R. 13103 relieves, for the time being, the problem as to deposits by continuing their exemption through December 31, 1971.

Section 8(c) of H.R. 13103 ameliorates to some extent the rule with respect to bonds issued by U.S. corporations. However, exemption is granted as to such bonds only if the obligor derived less than 20 percent of its gross income from sources within the United States for the 3-year period ending with the close of its taxable year ending prior to the nonresident alien's death. This exemption will apply to only a small fraction of the bonds now held by nonresident aliens. In view of the sensitivity of nonresident aliens to estate tax, it seems probable that a substantial portion of the U.S. bonds owned by them will be liquidated. We again question whether such a provision is desirable at this time when we are seeking to improve our balance of payments.

Sections 8(c) and 9(b), respectively setting forth the situs rules as to debt obligations for estate and gift tax purposes, are not the same. As a matter of consistency we recommend that the same situs rules be incorporated in both sections.

2. Dollar deposits with foreign branches of U.S. banks

The amendments made by sections 2 and 8 of H.R. 13103 will exempt nonresident aliens from income tax on interest on dollar deposits made by nonresident aliens with a foreign branch of a domestic bank and also will exempt such deposits from estate tax. These amendments meet the objections made in our prior report on H.R. 11297.

3. Income effectively connected with the conduct of a trade or business

Although section 2(d) of H.R. 13103 revises considerably the statutory provisions with respect to the effectively connected concept, there still is no definition of the term and the inherent vagueness which we criticized in our prior report, still persists.

Section 864(c) (2), as added by section 2(d) of H.R. 13103, eliminates, as an independent factor in determining whether income is effectively connected with the conduct of a business in the United States, the question of how the item is accounted for. However, the manner in which the item is accounted for still is to be considered in determining the applicability of the two statutory factors. This is preferable to the prior approach, but it still appears to be subject to the same basic objection we raised in our report on H.R. 11297, viz that it may trap the unsophisticated and be subject to manipulation by the sophisticated.

Section 864(c) (2), as added by section 2(d) of H.R. 13103, requires that a determination be made as to whether the fixed or determinable annual or periodical income subject to the 30 percent flat rate of tax is, or is not, effectively connected with the conduct of a trade or business.

On the other hand, section 864(c) (3), as added by section 2(d) of H.R. 13103, requires that all other income from sources within the United States be deemed to be effectively connected with the conduct of any trade or business carried on by the nonresident alien taxpayer. That this broadside approach does not produce fair results in all cases is shown by the following examples:

Assume in each case that the nonresident alien taxpayer is a partner in a firm engaged in manufacturing in the United States.

1. The taxpayer purchased a life insurance policy upon the life of X, and on X's death collected the insurance proceeds. Section 101(a) (2) is applicable and the gain is taxable. Such income has no connection whatsoever with the manufacturing business, but under section 864(c) (3) is deemed to be effectively connected with such business so as to be subject to tax at graduated rates.

2. The taxpayer owned a painting which cost him \$50,000 and is now worth \$200,000. He ships the painting from the United States to Europe and insures it for \$200,000. The ship sinks, the painting is lost and the taxpayer collects the full insurance. Under Revenue Ruling 60-278, 1960-2 C.B. 214, the resulting profit is deemed to be from sources within the United States. Although the profit has no connection with the business, it is deemed to be effectively connected with it and is subject to tax at graduated rates.

3. The nonresident alien taxpayer formerly resided in the United States, and while here purchased a home. The property is subject to a \$75,000 mortgage.