

interest income of these foreign central banks. Your committee believes that in the case of these foreign central banks of issue this income should continue to be exempt from U.S. tax because of the nature of the activities these banks perform for their governments.

Your committee also concluded that the Bank for International Settlements is, in effect, acting as an agent for a group of foreign central banks of issue and therefore it is also appropriate to extend the exemption for bank-deposit interest to deposits of this bank.

(c) *Explanation of provision.*—In view of the considerations set forth above, the bill amends the code to exempt from U.S. tax interest received by foreign central banks of issue and the Bank for International Settlements from U.S. bank deposits unless the deposits are held in connection with commercial transactions of these banks. After 1971, this will distinguish their tax treatment for interest on bank deposits from that accorded other foreign persons.

(d) *Effective date.*—These amendments are effective with respect to taxable years beginning after December 31, 1966.

4. *Rules for determining the source of dividends from foreign corporations (sec. 2(b) of the bill and sec. 861(a)(2) (B) and (C) of the code)*

(a) *Present law.*—Present law provides that all or a portion of dividends paid by a foreign corporation to nonresident aliens or foreign corporations is considered to be from U.S. sources and therefore subject to U.S. tax, but only if 50 percent or more of the income of the foreign corporation making the distribution is derived from sources within the United States during the preceding 3-year period. This tax applies where the foreign corporation paying the dividend has itself usually already paid a U.S. tax on this same income when it received the income. The tax involved, therefore, is a second tax on the dividend distribution from the foreign corporation. The portion of the dividend treated as being from U.S. sources, where the 50-percent test referred to above is met, is the same proportion of the dividend which the gross income of the foreign corporation during the immediately prior 3-year period, from U.S. sources, is of its gross income from all sources for that period.

(b) *Reasons for provision.*—Your committee's bill restricts the likelihood of this tax being imposed. This tax on the dividends of foreign corporations has given rise to little in revenue in the past. On the other hand, elimination of the tax provision would give an unfair advantage to foreign corporations substantially all of whose business is conducted in the United States. Consequently, your committee's bill restricts the scope of this tax by modifying the applicable rule of present law in two respects. Under the amended provision, the tax will only apply if the foreign corporation is engaged in trade or business within the United States and even in the case of a corporation so engaged, it will only apply if 80 percent (rather than 50 percent) of its income is effectively connected² to the conduct of such business.

The increase in the percentage requirement from 50 to 80 percent gives assurance that the second tax on this dividend income, which is difficult to collect from nonresident aliens and foreign corporations, will be imposed only where U.S. operations account for the bulk of the income being paid out. The limitation to income which is effectively

² The term "effectively connected" is explained in No. B-2 below under sec. 2(d) of the bill.