

(c) *Explanation of provision.*—The bill substantially revises the income tax treatment of foreign corporations. Under the bill the income of a foreign corporation is divided into two classifications.

(1) *Income not effectively connected.*—Fixed or determinable income of a foreign corporation from sources within the United States which is not effectively connected with the conduct of a trade or business within the United States, under your committee's bill, is taxable at a flat 30-percent rate (or lower treaty rate). The types of fixed or determinable income specified are the same as under present law with the same two additions provided in the case of nonresident aliens: (1) gains with respect to the sale of stock of a collapsible corporation, treated as ordinary income and (2) amounts of original issue discount which are treated as ordinary income received on retirement or sale or exchange of bonds or other evidences of indebtedness issued after September 28, 1965. As indicated in the case of the taxation of nonresident aliens, the source of this original issue discount is to be determined by the same rules as those applicable to interest income. As a result, if the corporation with respect to whose bonds the original issue discount arises is a domestic corporation which in the prior 3 years derives 80 percent or more of its income from foreign sources, then the original issue discount (interest), at the time of the retirement or sale or exchange of the bonds also will be considered as foreign source income.

Your committee has also clarified the language of present law which includes certain timber, coal, and iron ore royalties in the 30-percent list.

(2) *Income effectively connected.*—Income of a foreign corporation which is effectively connected with the conduct of a trade or business within the United States is taxable, under the bill, at the regular corporate income tax rates. In determining "taxable income" for this purpose, gross income includes only gross income that is "effectively connected" with the conduct of the trade or business within the United States.

(3) *Income from real property.*—Under present law (as explained with respect to nonresident alien individuals) it is not clear as to what situations or arrangements for the ownership by a foreign corporation of real property located in the United States will cause the foreign corporation to be considered as engaging in a trade or business within the United States. This is important to know because if a foreign corporation not engaged in a trade or business in the United States receives rents from U.S. real property, this rental income is taxable at the flat 30-percent rate (or applicable treaty rate) on the gross amount of such rents, without the allowance of any deductions attributable to the rental income. Consequently, the tax liability generated by this rental income may exceed the net rental income the corporation receives. Your committee believes that the law in this area should be clarified and doubts whether it is appropriate to tax the gross amount of this type of income.

Since the provisions of this amendment parallel the amendment provided in the case of real estate income of nonresident alien individuals, the explanation is not repeated here (see No. C-1(c)(3)(ii)).

(4) *Deductions.*—Under the bill, deductions are allowed in computing the tax imposed at the regular corporate rates only to the extent