E. MISCELLANEOUS INCOME TAX PROVISIONS, ETC.

1. Income affected by treaty (sec. 5(a) of the bill and sec. 894 of the code)

(*a*) *Present law.*—Existing income tax treaties generally provide that the exemptions from tax, or the reduction in rates, provided for in its provisions apply only to persons who do not have a permanent establishment in the United States. The "permanent establishment" concept of the treaties serves a similar purpose as the "engaged in a trade or business in the United States" concept of U.S. tax law. The effect of such a provision in a treaty, therefore, is to deny the benefits of a treaty exemption or reduced rate to a nonresident alien individual, or a foreign corporation, engaged in a trade or business in the United States through a permanent establishment.

(*b*) *Explanation of provision.*—Under the tax treatment provided for such persons by your committee's bill, the "engaged in trade or business in the United States" criteria is no longer the sole determinant of the method of taxing particular items of a nonresident alien individual's, or a foreign corporation's U.S. source income. Your committee's bill seeks to tax all such persons alike on their noneffectively connected U.S. source income whether or not they also are engaged in a trade or business in the United States. This result would not be achieved under treaty provisions if some aliens or foreign corporations, because of having a permanent establishment in the United States, are denied the benefits of treaty rates or exemptions.

Your committee's bill adds to the code a new subsection providing that for purposes of applying any exemption from, or any reduced rate of, tax granted by a treaty to which the United States is a party, with respect to income which is not effectively connected with the conduct of a trade or business within the United States, a nonresident alien individual or foreign corporation shall be deemed not to have a permanent establishment in the United States at any time during the taxable year. In other words, with respect to investment income not effectively connected to a trade or business, a nonresident alien or foreign corporation will be taxed at the lower treaty rate if one is provided. This provision does not apply in computing the special tax applicable to U.S. citizens who became expatriates with a primary purpose of avoiding tax.

(*c*) *Effective date.*—This new provision is effective for taxable years beginning after December 31, 1966.

2. Application of pre-1967 income tax provisions (sec. 5(b) of the bill and new sec. 896 of the code)

Unilaterally revising the statutory pattern of taxation of nonresident aliens and foreign corporations and granting favorable tax treatment to such persons may have the effect of making it more difficult to negotiate satisfactory tax treaties. At the same time, your committee believes that a systematic modernization of the U.S. income tax treatment of nonresident aliens and foreign corporations requires a modernization of the basic statutory provisions.

To prevent a deterioration in our position in negotiating treaties while at the same time modernizing these statutory provisions, your committee has added a provision to the tax laws which generally