

SUMMARY

A. Effectively Connected Concept.

1. *Foreign Source Income.* — The purposes stated by the Report of the Ways and Means Committee for taxing specified rents and royalties, specified dividends, interest, and gains, and certain income from sales of goods made through a U.S. office, if “effectively connected” with the conduct of a trade or business in the U.S., are to prevent the use of the U.S. as a “tax haven” with respect to certain types of transactions and to impose tax on “income generated from U.S. business activities.”

2. *“Tax Haven” Purpose.* — This purpose appears to be specious in that (1) the scope of the bill goes beyond “tax haven” situations; (2) any abuses which exist could more appropriately be corrected by other countries; and (3) legislation by the U.S. would only drive the activities affected to countries which impose no taxes.

3. *Purpose of Taxing “Income Generated from U.S. Business Activities”.* — The bill would change the U.S. method of taxing the income of foreign corporations from one which meshes well into the established international system which has been developed in the income tax laws of the principal trading nations into one which would conflict with that system and create unwarranted double taxation. Income tax laws of most countries do not seek to tax income from sources outside their borders merely because of incidental and ancillary activities within their borders. It still is in the self-interest of the U.S. to adhere to this generally recognized principle. Taxation based on the “effectively connected” concept would tend to discourage purchasing within the country and would prompt the removal of offices which now furnish investment and employment in the country.

The bill applies the “effectively connected” concept in a one-sided manner, and does not recognize the right of other countries to apply a similar rule, in that it does not permit U.S.-source income of foreign corporations to be exempt to the extent that foreign offices and activities help to generate the income and does not even modify the limitations on U.S. foreign tax credits so as to allow credit for foreign taxes imposed on U.S.-source income “effectively connected” with foreign business activities.

4. *Conflict with U.S. Tax Treaties.* — The bill would come into conflict with most, if not all, of the existing tax treaties to which the U.S. is a party. Some treaties prohibit the taxation of foreign source income as attributable to a U.S. office; two of the recently proposed treaties expressly embody our existing source rules. Others limit such taxation to cases where the office qualifies as a permanent establishment and then limit the amount