

PRESENT LAW

A foreign corporation engaged in trade or business in the United States is taxed under section 882 of the Internal Revenue Code, which provides that such corporation shall be taxable in the same manner as a domestic corporation (that is, on its net income at the rates prescribed by Section 11 of the Code), except that it is only taxable on its income from sources within the United States. It is not taxable on income derived from sources without the United States. Those business expenses which are directly identifiable with United States source income are allowable deductions plus the allocable share of other expenses which are related to earning United States source income, but the amount of which cannot be specifically determined. In this latter case, the expenses are deductible in the ratio of gross income from sources within the United States to the total income of the bank from all sources. (Section 861(b) and 882(c)(2) of the Code; Treasury Regulation Section 1.882-3(b)(2) and 1.873-1(a)(1)).

Interest income derived from a foreign government, a nonresident alien individual, a foreign corporation or other entity not engaged in trade or business in the United States is income from sources without the United States and is exempt from United States income tax. (Section 861(a)(1) and 862(a)(1)). Furthermore, interest income received from a resident alien individual, a resident foreign corporation (i.e. one engaged in trade or business in the United States), or a domestic corporation is also exempt from Federal income tax when such person derives less than 20% of its gross income from sources within the United States for the three preceding years or for the period of its existence if less than three years. (Section 861(a)(1)(B)).

PROPOSED LAW

The proposed Bill departs to a considerable extent from the foregoing principles and will have a serious and arbitrary effect on this taxpayer. Under the Bill in its present form, the gross income of a resident foreign corporation would be divided into two categories (H.R. 13103, Section 4(b)):

- (1) Gross income which is effectively connected with the conduct of a trade or business within the United States;
- (2) Gross income which is derived from sources within the United States and which is not effectively connected with the conduct of a trade or business in the United States.

The first category of income would be taxed at the regular corporate rates or 22% and 48% under Section 11 of the Code after an allowance for the permitted deductions (H.R. 13103, Section 4(b) amending Section 882(a) and (c)), or at the capital gain rate of 25% under Section 1201(a) of the Code. The factors to be taken into account in order to ascertain whether an item of income is "effectively connected" with the conduct of a trade or business in the United States are (H.R. 13103, Section 2(d)):

- (1) The income gain or loss is derived from assets used in or held for use in the conduct of such trade or business, or
- (2) The activities of the trade or business were a material factor in the realization of the income, gain or loss.

In determining whether either of these factors are present to render income as being effectively connected with the conduct of a United States trade or business, due regard shall be given as to whether or not the assets, income, gain or loss is accounted for through the United States place of business. (Proposed Section 864(c)(2) as set forth in Section 2(d) of H.R. 13103). While income from sources within the United States may be effectively connected with the conduct of a United States trade or business, only certain specified types of income from sources without the United States can be so treated. Of particular concern in this latter instance to Barclays Bank D.C.O. is the provision that dividends, interest, and gain or loss from the sale or exchange of stock, notes, bonds, or other evidences of indebtedness derived in the active conduct of a banking business within the United States would be subject to Federal income tax, if such income is "effectively connected" with an office or other fixed place of business within the United States. (Proposed Section 882(b)(2) as contained in Section 4(b) of H.R. 13103).

Income from sources within the United States, which is not "effectively connected" with the conduct of a trade or business in the United States, would be taxed at a flat 30% rate (or applicable treaty rate). As under present law applying to nonresident foreign corporations, no deductions would be permitted even though there may be expenses related to earning such income.