

pletely untoward result since not infrequently the activities carried on by the United States place of business will, in an economic sense, have generated only a fraction of the income in question. For instance, in example (i), above, the ownership of the patent rights in the particular country will have been the principal source of such income viewed in an economic sense. Therefore, if Section 864(c) (4) (B) is to be retained in something resembling its present form, provision should be made for allocating to the United States place of business only that portion of the income in question which is economically attributable to the United States place of business. This might be done by adopting principles of allocation under section 482 of the Code such that the U.S. office would be taxed upon the portion of the income in question attributable to its selling or negotiating function.

Effective Date. Excluded from consideration in determining whether income from non-United States sources is to be treated as effectively connected income are activities attributable to a binding contract entered into on or before February 24, 1966, carried out "in the United States on or before such date in negotiating or carrying out such contract." It is suggested that the description of excluded activities parallel the statutory language contained in proposed Section 864(c) (4) (iii), just discussed, as follows: "activities conducted through an office or other fixed place of business within the United States."

B. Income from Sources within the United States

As noted above, we agree in principle with the use of the "effectively connected" concept to free from regular rate taxation investment income of foreign taxpayers notwithstanding their being engaged in trade or business in the United States. The statutory "effectively connected" test is necessarily vague, and, as a result, it will be difficult in many instances to advise nonresident aliens with any degree of specificity whether or not passive income will be considered "effectively connected."

One of the difficulties arises from the use of an accounting factor in determining whether income is "effectively connected." This is a carryover, somewhat modified, from the definition of "effectively connected" in H.R. 11297. Under the proposed statute, the determination of whether investment and other fixed or determinable income and capital gains from United States sources is "effectively connected" with a United States business is made on the basis of whether

(a) the income is derived from assets used, or held for use in the conduct of a United States business, or

(b) the activities of the United States business were a material factor in the realization of the income.

In determining whether factor (a) or factor (b) is present in a particular case, the statute provides that "due regard shall be given to whether or not such asset or such income, gain or loss was accounted for through such trade or business." In H.R. 11297, this "accounting" factor was on a par with the other two factors, (a) and (b), in determining whether income was effectively connected with a trade or business. The use of an accounting factor in the statutory definition does not in the first instance seem desirable, although it is certainly better to reduce it from its status under H.R. 11297 where the presence of such factor alone might have resulted in treatment of income as effectively connected income.

The basic definition in the statute of what constitutes "effectively connected" income is followed by a catchall definition of other types of income to be treated as effectively connected income, irrespective of whether so connected in fact (proposed Section 864(c) (3)):

"(3) OTHER INCOME FROM SOURCES WITHIN UNITED STATES.—All income, gain, or loss from sources within the United States (other than income, gain, or loss to which paragraph (2) applies) shall be treated as effectively connected with the conduct of a trade or business within the United States."

The income, gain, or loss "to which paragraph (2) applies" (that is, Section 864(c) (2)) is, in turn, described by cross-reference to other sections of the Code. It is suggested that the same cross-references be made in Section 864(c) (3) so that the parenthetical portion of Paragraph (3) would read as follows:

"* * * (other than income from sources within the United States of the types described in section 871(a) (1) or section 881(a) or gain or loss from sources within the United States from the sale or exchange of capital assets)"