

per cent (or the lower applicable treaty rate) whether or not the foreign owner is engaged in business in the United States. The second purpose was to prevent abuse of the American source rules by foreign corporations which use the U.S. as a tax haven.

An analysis of the origin of the "effectively connected" concept reveals that this is no term of art. This expression, which did not appear in any of the Model Tax Conventions of the Fiscal Committee of the League of Nations, was apparently used for the first time in art. 10, para. 4, art. 11, para. 4 and art. 12, para. 3 of the Draft Double Taxation Convention on Income and Capital of 1963 prepared by the Fiscal Committee of the Organization for Economic Cooperation and Development (OECD). In recent times this expression has also been used in the income tax treaties of the U.S. with Germany, the Netherlands and the United Kingdom in connection with the allocation of earnings and profits to a permanent establishment.¹

It appears that the expression "effectively connected" is the English translation of the prevailing European concept concerning the attribution of dividends, interest and royalties to a permanent establishment. This is confirmed by the fact that the OECD Draft Convention, which first made use of this term and predominantly reflects the views of its European members states, also employs this concept for delimiting certain categories of income, namely, dividends, interest and royalties to be attributed to a permanent establishment. If such dividends, interest and royalties are not "effectively connected" with the permanent establishment and, therefore, do not constitute "business profits" of the permanent establishment within the ambit of art. 7 of the OECD Draft Treaty, they are not taxable in the state in which they arise (i.e. in the state of the permanent establishment) but rather in the state of the recipient. This same rule is also to be found in the U.S. income tax treaties with Germany and the United Kingdom.

In the light of this historical background it appears that H.R. 13103 proposes to incorporate the existing treaty law with regard to the distinction between business and investment income into domestic tax law. This transposition is apt to cause increased complexities because of its effect upon the traditional source rules in the U.S. Code. The distinction between business and investment income means that one type of income, e.g. royalties, may have two different sources depending upon whether in the particular facts it is business income effectively connected with a permanent establishment or investment income not effectively connected with a permanent establishment. It is this relation to the traditional source rules that could lead to unnecessary theoretical and practical difficulties. Such difficulties may arise if the provisions of H.R. 13103 according to which the President may under certain circumstances cancel the benefits of this bill prove effective in causing other countries to adopt this system of taxing foreigners. Thus it is conceivable that two foreign countries might tax someone who is a "foreigner" as to both of those countries on the same income. For example, the royalty income of a U.S. citizen may be taxed by France and Switzerland because it has its source in France as business income of a permanent establishment in France and also has its source in Switzerland as investment income paid by a resident of Switzerland. If this occurs, double taxation can only be avoided, if France agrees to adopt something like a sect. 906 credit which is unlikely in view of its present tax system.

In addition, it is hard to understand why H.R. 13103 limits the application of the "effectively connected" concept to three specific types of foreign source income, namely rents and royalties, dividends and interest derived in the active conduct of a banking or similar business and certain sales income attributable to a U.S. sales office.

In the interest of maintaining a logically structured tax system, we therefore recommend that Congress abolish the "effectively connected" concept altogether or else at least limit its application to U.S. source income. It should then consider possible changes in the domestic source rules with regard to dividends, interest, royalties and sales income. In this respect it is to be observed that the Report of the Ways and Means Committee does not explain why these source rules cannot be revised so as to prevent their present abuse. One such revision, for instance, might be to substitute the "destination" test for the

¹ Cf. art. 6, para. 7; art. 7, para. 3; art. 8, para. 4; and art. 16A, para. 2 of the treaty with Germany, art. 7, para. 3; art. 8, para. 2, and art. 9, para. 3 of the Suppl. Prot. of December 30, 1965, to the treaty with the Netherlands; art. 6, para. 4 and 5; art. 7, para. 3 and art. 8, para. 3, of the Suppl. Prot. of March 17, 1966, to the treaty with the United Kingdom.