SOME GENERAL OBSERVATIONS

It is our conviction that there would be an adverse economic impact from application to foreign source income of the proposed "effectively connected" concept.

Under Section 2(d) of the bill, rental and royalty income derived by a foreign corporation from the use outside the United States of patents, copyrights, trademarks and other intangible property, and attributable to an office or other fixed place of business in the United States would be deemed to be "effectively connected" with the conduct by the foreign corporation of a trade or business in the United States and consequently subject to U.S. taxation even though such income is also deemed to be derived from foreign sources. The same rule would apply to sales income attributable to a U.S. business location of the foreign corporation; however, such sales would not be deemed "effectively connected" if the goods in question are sold for use, consumption, or disposition outside this country, *and* an office or other fixed place of business of the foreign corporation outside the U.S. "participated materially" in the sale. The bill would include any foreign corporation without regard to its ownership—thus it would cover foriegn corporate subsidiaries of American parent companies.

The basic purpose of this legislation, at least in its initial stages, was to stimulate foreign investment in the United States. The subsequent addition of the "effectively connected" concept and its application to extend U.S. taxation to certain foreign source income of foreign subsidiaries of U.S. companies, is, we submit, unrelated to this legislative objective and, moreover, it is incompatible with a number of other basic national economic objectives. There are many instances when it is desirable for commercial nontax reasons relating to the expansion of foreign markets to establish a U.S. business location for the foreign subsidiary or to have certain functions connected with this foreign business performed by parent company personnel located in the United States. To the extent that this legislation permits U.S. taxation of income from the use of patents and trademarks abroad and income from the sale of goods used or consumed abroad, it is obviously a deterrent to expansion of this type of foreign business. Thus, it hinders the basic governmental policy of strengthening the overall U.S. position in respect to the international balance of payments.

There are a number of ways in which this problem can be ameliorated. One would be to insert a proviso in the bill that its separate provisions are not to be construed in such a way as to either impose a U.S. tax liability when none has existed in the past or increase an already existing tax. Another alternative, already suggested to the Ways and Means Committee, would be to provide that the "effectively connected" provisions are not to apply to foreign source income of a foreign corporation when the latter is a "controlled foreign corporation" under Subpart F of the Internal Revenue Code, that is, when it is a foreign subsidiary of a U.S. company.

In addition to these fundamental methods of insuring that application of the "effectively connected" concept does not injure American business abroad, we have some additional suggestions relating to the specifics of Section 2(d) of the bill. The parenthetical references indicate provisions of the Internal Revenue Code which would be affected by Section 2(d).

PERFORMANCE OF NONMANAGEMENT TASKS BY THE U.S. PARENT COMPANY (CODE SECTION 864(C)(4)(B))

The Ways and Means Committee report on the bill makes it clear that a foreign subsidiary will not be deemed to have a business location in the United States merely because its U.S. parent company exercises general supervision and control over the policies of the subsidiary.[1] We note, however, that under Example (3) following the statement of this general rule in the report, if orders received by the subsidiary are subject to review by an officer of the parent company before acceptance, the subsidiary will be deemed to have a business office in the United States. Such a review policy is a common operating practice—and good business practice—with respect to orders received by a foreign subsidiary and we think it is perfectly compatible with the exercise of "general supervision and control" by the parent company. We urge that Example (3) be amended to conform with this interpretation.

[1] House Report No. 1450, 89th Congress, 2d Session, p. 63.