(1) a corporation entitled to the benefits of section 931, by reason of receiving a large percentage of its gross income from sources within a possession of the United States; and

(2) a corporation organized under the China Trade Act, 1922 (15 U.S.C., chapter 4), and entitled to the deduction provided in section 941.

[(d)] *(e)* CROSS REFERENCE.—

(1) For deductions of income, war profits, and excess profits taxes paid to a foreign country or a possession of the United States, see sections 164 and 275.

(2) For right of each partner to make election under this section, see section 703 (b).

(3) For right of estate or trust to the credit for taxes imposed by foreign countries and possessions of the United States under this section, see section 642 (a) (2).

(4) For reduction of credit for failure of a United States person to furnish certain information with respect to a foreign corporation controlled by him, see section 6038.

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SEC. 906. NONRESIDENT ALIEN INDIVIDUALS AND FOREIGN CORPORATIONS.

(a) ALLOWANCE OF CREDIT.—A nonresident alien individual or a foreign corporation engaged in trade or business within the United States during the taxable year (or during any preceding taxable year beginning after December 31, 1965) shall be allowed a credit under section 901 for the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year (or deemed, under section 902, paid or accrued during the taxable year) to any foreign country or possession of the United States with respect to income effectively connected with the conduct of the trade or business within the United States.

(b) SPECIAL RULES.—

(1) For purposes of subsection (a) and for purposes of determining the deductions allowable under sections 873(a) and 882(c), in determining the amount of any tax paid or accrued to any foreign country or possession there shall not be taken into account any amount of tax to the extent the tax so paid or accrued is imposed with respect to income which would not be taxed by such foreign country or possession but for the fact that—

(A) in the case of a nonresident alien individual, such individual is a citizen or resident of such foreign country or possession, or

(B) in the case of a foreign corporation, such corporation was created or organized under the law of such foreign country or possession or is domiciled for tax purposes in such country or possession.

(2) For purposes of subsection (a), in applying section 904 the taxpayer's taxable income shall be treated as consisting only of the

taxable income effectively connected with the taxpayer's conduct of the trade or business within the United States.

(3) The credit allowed pursuant to subsection (a) shall not be allowed against any tax imposed by section 871(a) (relating to income of nonresident alien individual not connected with United States business) or 881 (relating to income of foreign corporations not connected with United States business).

(4) For purposes of sections 902(a) and 78, a foreign corporation choosing the benefits of this subpart which receives dividends shall, with respect to such dividends, be treated as a domestic corporation.

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Subpart D—Possessions of the United States

SEC. 931. INCOME FROM SOURCES WITHIN POSSESSIONS OF THE UNITED STATES.

(a) GENERAL RULE.—In the case of citizens of the United States or domestic corporations, gross income means only gross income from sources within the United States if the conditions of both paragraph (1) and paragraph (2) are satisfied:

(1) THREE-YEAR PERIOD.—If 80 percent or more of the gross income of such citizen or domestic corporation (computed without the benefit of this section) for the 3-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States; and

(2) TRADE OR BUSINESS.—If—

(A) in the case of such corporation, 50 percent or more of its gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States; or

(B) in the case of such citizen, 50 percent or more of his gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States either on his own account or as an employee or agent of another.

(b) AMOUNTS RECEIVED IN UNITED STATES.—Notwithstanding subsection (a), there shall be included in gross income all amounts received by such citizens or corporations within the United States, whether derived from sources within or without the United States.

(c) DEFINITION.—For purposes of this section, the term "possession of the United States" does not include the Virgin Islands of the United States, and such term when used with respect to citizens of the United States does not include Puerto Rico.

[(d) DEDUCTIONS.—

[(1) Citizens of the United States entitled to the benefits of this section shall have the same deductions as are allowed by section 873 in the case of a nonresident alien individual engaged in trade or business within the United States.

[(2) Domestic corporations entitled to the benefits of this section shall have the same deductions as are allowed by section 882 (c) in the case of a foreign corporation engaged in trade or business within the United States.]

(d) DEDUCTIONS.—

(1) GENERAL RULE.—Except as otherwise provided in this subsection and subsection (e), in the case of persons entitled to the benefits of this section the deductions shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined as provided in part I, under regulations prescribed by the Secretary or his delegate.

(2) EXCEPTIONS.—The following deductions shall be allowed whether or not they are connected with income from sources within the United States:

(A) The deduction, for losses not connected with the trade or business if incurred in transactions entered into for profit, allowed by section 165(c)(2), but only if the profit, if such transaction had resulted in a profit, would be taxable under this subtitle.

(B) The deduction, for losses of property not connected with the trade or business if arising from certain casualties or theft, allowed by section 165(c)(3), but only if the loss is of property within the United States.

(C) The deduction for charitable contributions and gifts allowed by section 170.

(3) DEDUCTION DISALLOWED.—

For disallowance of standard deduction, see section 142(b)(2).

(e) DEDUCTION FOR PERSONAL EXEMPTION.—A citizen of the United States entitled to the benefits of this section shall be allowed a deduction for only one exemption under section 151.

(f) ALLOWANCE OF DEDUCTIONS AND CREDITS.—Persons entitled to the benefits of this section shall receive the benefit of the deductions and credits allowed to them in this subtitle only by filing or causing to be filed with the Secretary or his delegate a true and accurate return of their total income received from all sources in the United States, in the manner prescribed in subtitle F, including therein all the information which the Secretary or his delegate may deem necessary for the calculation of such deductions and credits.

(g) FOREIGN TAX CREDIT.—Persons entitled to the benefits of this section shall not be allowed the credits against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

(h) INTERNEES.—In the case of a citizen of the United States interned by the enemy while serving as an employee within a possession of the United States—

(1) if such citizen was confined in any place not within a possession of the United States, such place of confinement shall, for purposes of this section, be considered as within a possession of the United States; and

(2) subsection (b) shall not apply to any compensation received within the United States by such citizen attributable to the period of time during which such citizen was interned by the enemy.

(i) EMPLOYEES OF THE UNITED STATES.—For purposes of this section, amounts paid for services performed by a citizen of the United States as an employee of the United States or any agency thereof shall be deemed to be derived from sources within the United States.

SEC. 932. CITIZENS OF POSSESSIONS OF THE UNITED STATES.

(a) GENERAL RULE.—Any individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United States shall be subject to taxation under this subtitle [only as to income derived from sources within the United States, and in such case the tax shall be computed and paid] in the same manner and subject to the same conditions as in the case of [other persons who are taxable only as to income derived from such sources] *a nonresident alien individual.* This section shall have no application in the case of a citizen of Puerto Rico.

(b) VIRGIN ISLANDS.—Nothing in this section shall be construed to alter or amend the Act entitled "An Act making appropriations for the naval service for the fiscal year ending June 30, 1922, and for other purposes", approved July 12, 1921 (48 U.S.C. 1397), relating to the imposition of income taxes in the Virgin Islands of the United States.

(c) GUAM.—

For applicability of United States income tax laws in Guam, see section 31 of the Act of August 1, 1950 (48 U.S.C. 1421i); for disposition of the proceeds of such taxes, see section 30 of such Act (48 U.S.C. 1421h).

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Subpart F—Controlled Foreign Corporations

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SEC. 952. SUBPART F INCOME DEFINED.

(a) IN GENERAL.—For purposes of this subpart, the term "subpart F income" means, in the case of any controlled foreign corporation, the sum of—

(1) the income derived from the insurance of United States risks (as determined under section 953), and

(2) the foreign base company income (as determined under section 954).

[(b) EXCLUSION OF UNITED STATES INCOME.—Subpart F income does not include any item includible in gross income under this chapter (other than this subpart) as income derived from sources within the United States of a foreign corporation engaged in trade or business in the United States.]

(b) EXCLUSION OF UNITED STATES INCOME.—In the case of a controlled foreign corporation, subpart F income does not include any item of income effectively connected with the conduct by such corporation of a trade or business within the United States unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a treaty obligation of the United States.

(c) LIMITATION.—For purposes of subsection (a), the subpart F income of any controlled foreign corporation for any taxable year shall not exceed the earnings and profits of such corporation for such year reduced by the amount (if any) by which—

(1) an amount equal to—

(A) the sum of the deficits in earnings and profits for prior taxable years beginning after December 31, 1962, plus

(B) the sum of the deficits in earnings and profits for taxable years beginning after December 31, 1959, and before January 1, 1963 (reduced by the sum of the earnings and profits for such taxable years); exceeds

(2) an amount equal to the sum of the earnings and profits for prior taxable years beginning after December 31, 1962, allocated to other earnings and profits under section 959(c)(3).

For purposes of the preceding sentence, any deficit in earnings and profits for any prior taxable year shall be taken into account under paragraph (1) for any taxable year only to the extent it has not been taken into account under such paragraph for any preceding taxable year to reduce earnings and profits of such preceding year.

(d) SPECIAL RULE IN CASE OF INDIRECT OWNERSHIP.—For purposes of subsection (c), if—

(1) a United States shareholder owns (within the meaning of section 958(a)) stock of a foreign corporation, and by reason of such ownership owns (within the meaning of such section) stock of any other foreign corporation, and

(2) any of such foreign corporations has a deficit in earnings and profits for the taxable year,

then the earnings and profits for the taxable year of each such foreign corporation which is a controlled foreign corporation shall, with respect to such United States shareholder, be properly reduced to take into account any deficit described in paragraph (2) in such manner as the Secretary or his delegate shall prescribe by regulations.

SEC. 953. INCOME FROM INSURANCE OF UNITED STATES RISKS.

(a) GENERAL RULE.—For purposes of section 952(a)(1), the term "income derived from the insurance of United States risks" means that income which—

(1) is attributable to the reinsurance or the issuing of any insurance or annuity contract—

(A) in connection with property in, or liability arising out of activity in, or in connection with the lives or health of residents of, the United States, or

(B) in connection with risks not included in subparagraph (A) as the result of any arrangement whereby another corporation receives a substantially equal amount of premiums or other consideration in respect to any reinsurance or the issuing of any insurance or annuity contract in connection with property in, or liability arising out of activity in, or in connection with the lives or health of residents of, the United States, and

(2) would (subject to the modifications provided by paragraphs (1), (2), and (3) of subsection (b)) be taxed under subchapter L of this chapter if such income were the income of a domestic insurance corporation.

This section shall apply only in the case of a controlled foreign corporation which receives, during any taxable year, premiums or other consideration in respect of the reinsurance, and the issuing, of insurance and annuity contracts described in paragraph (1) in excess of 5 percent of the total of premiums and other consideration received during such taxable year in respect of all reinsurance and issuing of insurance and annuity contracts.

(b) SPECIAL RULES.—For purposes of subsection (a)—

(1) In the application of part I of subchapter L, life insurance company taxable income is the gain from operations as defined in section 809(b).

(2) A corporation which would, if it were a domestic insurance corporation, be taxable under part II of subchapter L shall apply subsection (a) as if it were taxable under part III of subchapter L.

(3) The following provisions of subchapter L shall not apply:

(A) Section 809(d)(4) (operations loss deduction).

(B) Section 809(d)(5) (certain nonparticipating contracts).

(C) Section 809(d)(6) (group life, accident, and health insurance).

(D) Section 809(d)(10) (small business deduction).

(E) Section 817(b) (gain on property held on December 31, 1958, and certain substituted property acquired after 1958).

(F) Section [832(b)(5)] *832(c)(5)* (certain capital losses)

(4) The items referred to in—

(A) section 809(c)(1) (relating to gross amount of premiums and other considerations),

(B) section 809(c)(2) (relating to net decrease in reserves),

(C) section 809(d)(2) (relating to net increase on reserves), and

(D) section 832(b)(4) (relating to premiums earned on insurance contracts),

shall be taken into account only to the extent they are in respect of any reinsurance or the issuing of any insurance or annuity contract described in subsection (a)(1).

(5) All items of income, expenses, losses, and deductions (other than those taken into account under paragraph (4)) shall be properly allocated or apportioned under regulations prescribed by the Secretary or his delegate.

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Subchapter P—Capital Gains and Losses

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PART IV—SPECIAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES

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SEC. 1248. GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS.

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(d) EXCLUSIONS FROM EARNINGS AND PROFITS.—For purposes of this section, the following amounts shall be excluded, with respect to any United States person, from the earnings and profits of a foreign corporation:

* * * * * * *

(4) UNITED STATES INCOME.—Any item includible in gross income of the foreign corporation under this chapter—

(A) for any taxable year beginning before January 1, 1966, as income derived from sources within the United States of a foreign corporation engaged in trade or business [in] *within* the United States, *or*

(B) for any taxable year beginning after December 31, 1965, as income effectively connected with the conduct by such corporation of a trade or business within the United States.

This paragraph shall not apply with respect to any item which is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a treaty obligation of the United States.

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SEC. 1249. GAIN FROM CERTAIN SALES OR EXCHANGES OF PATENTS ETC., TO FOREIGN CORPORATIONS.

(a) GENERAL RULE.—[Except as provided in subsection (c), gain] *Gain* from the sale or exchange after December 31, 1962, of a patent, an invention, model, or design (whether or not patented), a copyright, a secret formula or process, or any other similar property right to any foreign corporation by any United States person (as defined in section 7701(a)(30)) which controls such foreign corporation shall, if such gain would (but for the provisions of this subsection) be gain from the sale or exchange of a capital asset or of property described in section 1231, be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231.

(b) CONTROL.—For purposes of subsection (a), control means, with respect to any foreign corporation, the ownership, directly or indirectly, of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote. For purposes of this subsection, the rules for determining ownership of stock prescribed by section 958 shall apply.

SEC. 1250. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE REALTY.

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(d) Exceptions and Limitations.—

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(3) CERTAIN TAX-FREE TRANSACTIONS.—If the basis of property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, 361, 371(a), 374(a), 721, or 731, then the amount of gain taken into account by the transferor under subsection (a)(1) shall not exceed the amount of gain recognized to the transferor on the transfer of such property (determined without regard to this section). This paragraph shall not apply to—

(*A*) a disposition to an organization (other than a cooperative described in section 521) which is exempt from [the] tax imposed by this chapter, *or*

(B) a transfer of property by a nonresident alien individual, a foreign estate or trust, or a foreign partnership, to a domestic corporation in exchange for stock or securities in such corporation in a transaction to which section 351 applies.

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CHAPTER 3—WITHHOLDING OF TAX ON NONRESIDENT ALIENS AND FOREIGN CORPORATIONS AND TAX-FREE COVENANT BONDS

Subchapter A—Nonresident Aliens and Foreign Corporations

SEC. 1441. WITHHOLDING OF TAX ON NONRESIDENT ALIENS.

(a) GENERAL RULE.—Except as otherwise provided in subsection (c), all persons, in whatever capacity acting (including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States) having the control, receipt, custody, disposal, or payment of any of the items of income specified in subsection (b) (to the extent that any of such items constitutes gross income from sources within the United States), of any nonresident alien individual, or of any partnership not engaged in trade or business within the United States and composed in whole or in part of nonresident aliens, shall (except in the cases provided for in section 1451 and except as otherwise provided in regulations prescribed by the Secretary or his delegate under section 874) deduct and withhold from such items a tax equal to 30 percent thereof, except that in the case of any item of income specified in the second sentence of subsection (b), the tax shall be equal to 14 percent of such item.

(b) INCOME ITEMS.—The items of income referred to in subsection (a) are interest [(except interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States)], dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, [and amounts described in section 402(a)(2), section 403(a)(2), section 631 (b) and (c), and section 1235, which are considered to be gains from the sale or exchange of capital assets.] *and gains described in section 402(a)(2), 403(a)(2), or 631 (b) or (c), and gains on transfers described in section 1235.* The items of income referred to in subsection (a) from which tax shall be deducted and withheld at the rate of 14 percent are—

(1) that portion of any scholarship or fellowship grant which is received by a nonresident alien individual who is temporarily present in the United States as a nonimmigrant under subparagraph (F) or (J) of section 101(a)(15) of the Immigration and Nationality Act, as amended, and which is not excluded from gross income under section 117(a)(1), solely by reason of section 117(b)(2)(B); and

(2) amounts described in subparagraphs (A), (B), (C), and (D) of section 117(a)(2) which are received by any such nonresident alien individual and which are incident to a scholarship or fellowship grant to which section 117(a)(1) applies, but only to the extent such amounts are includible in gross income.

(c) EXCEPTIONS.—

[(1) DIVIDENDS OF FOREIGN CORPORATIONS.—No deduction or withholding under subsection (a) shall be required in the case of dividends paid by a foreign corporation unless (A) such corporation is engaged in trade or business within the United States, and (B) more than 85 percent of the gross income of such corporation for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under part I of subchapter N of chapter 1.]

(1) INCOME CONNECTED WITH UNITED STATES BUSINESS.—*No deduction or withholding under subsection (a) shall be required in the case of any item of income (other than compensation for personal services) which is effectively connected with the conduct of a trade or business within the United States and on which a tax is imposed for the taxable year pursuant to section 871(b)(1).*

(2) OWNER UNKNOWN.—The Secretary or his delegate may authorize the tax under subsection (a) to be deducted and withheld from the interest upon any securities the owners of which are not known to the withholding agent.

(3) BONDS WITH EXTENDED MATURITY DATES.—The deduction and withholding in the case of interest on bonds, mortgages, or deeds of trust or other similar obligations of a corporation, within subsections (a), (b), and (c) of section 1451 were it not for the fact that the maturity date of such obligations has been extended on or after January 1, 1934, and the liability assumed by the debtor exceeds 27½ percent of the interest, shall not exceed the rate of 27½ percent per annum.

(4) COMPENSATION OF CERTAIN ALIENS.—Under regulations prescribed by the Secretary or his delegate, [there] *compensation for personal services* may be exempted from deduction and withholding under subsection (a) [the compensation for personal services of—

[(A) nonresident alien individuals who enter and leave the United States at frequent intervals, and

[(B) a nonresident alien individual for the period he is temporarily present in the United States as a nonimmigrant under subparagraph (F) or (J) of section 101(a)(15) of the Immigration and Nationality Act, as amended].

(5) SPECIAL ITEMS.—In the case of [amounts described in section 402(a)(2), section 403(a)(2), section 631 (b) and (c), and section 1235, which are considered to be gains from the sale or exchange of capital assets,] *gains described in section 402(a)(2), 403(a)(2), or 631 (b) or (c), and gains on transfers described in section 1235,* the amount required to be deducted and withheld shall, if the amount of such gain is not known to the withholding agent, be such amount, not exceeding 30 percent of the [proceeds from such sale or exchange] *amount payable,* as may be necessary to assure that the tax deducted and withheld shall not be less than 30 percent of such gain.

(6) PER DIEM OF CERTAIN ALIENS.—No deduction or withholding under subsection (a) shall be required in the case of amounts of per diem for subsistence paid by the United States Government (directly or by contract) to any nonresident alien individual who is engaged in any program of training in the United States under the Mutual Security Act of 1954, as amended.

(d) ALIEN RESIDENT OF PUERTO RICO.—For purposes of this section, the term "nonresident alien individual" includes an alien resident of Puerto Rico.

SEC. 1442. WITHHOLDING OF TAX ON FOREIGN CORPORATIONS.

In the case of foreign corporations subject to taxation under this subtitle [not engaged in trade or business within the United States], there shall be deducted and withheld at the source in the same manner and on the same items of income as is provided in section 1441 or section 1451 a tax equal to 30 percent thereof; except that, in the case of interest described in section 1451 (relating to tax-free covenant bonds), the deduction and withholding shall be at the rate specified therein. *For purposes of the preceding sentence, the reference in section 1441(c)(1) to section 871(b)(1) shall be treated as referring to section 882(a).*

Subchapter C—Application of Withholding Provisions

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SEC. 1461. [RETURN AND PAYMENT OF] *LIABILITY FOR* WITHHELD TAX.

Every person required to deduct and withhold any tax under this chapter [shall, on or before March 15 of each year, make return thereof and pay the tax to the officer designated in section 6151. Every such person] is hereby made liable for such tax and is hereby indemnified against the claims and demands of any person for the amount of any payments made in accordance with the provisions of this chapter.

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Subtitle B—Estate and Gift Taxes

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CHAPTER 11—ESTATE TAX

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Subchapter A—Estates of Citizens or Residents

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PART I—TAX IMPOSED

SEC. 2001. RATE OF TAX.

A tax computed in accordance with the following table is hereby imposed on the transfer of the taxable estate, determined as provided in section 2051, of every decedent, citizen or resident of the United States dying after the date of enactment of this title:

If the taxable estate is:	The tax shall be:
Not over $5,000	3% of the taxable estate.
Over $5,000 but not over $10,000	$150, plus 7% of excess over $5,000.
Over $10,000 but not over $20,000	$500, plus 11% of excess over $10,000.
Over $20,000 but not over $30,000	$1,600, plus 14% of excess over $20,000.
Over $30,000 but not over $40,000	$3,000, plus 18% of excess over $30,000.
Over $40,000 but not over $50,000	$4,800, plus 22% of excess over $40,000.
Over $50,000 but not over $60,000	$7,000, plus 25% of excess over $50,000.
Over $60,000 but not over $100,000	$9,500, plus 28% of excess over $60,000.
Over $100,000 but not over $250,000	$20,700, plus 30% of excess over $100,000.
Over $250,000 but not over $500,000	$65,700, plus 32% of excess over $250,000.
Over $500,000 but not over $750,000	$145,700, plus 35% of excess over $500,000.
Over $750,000 but not over $1,000,000	$233,200, plus 37% of excess over $750,000.
Over $1,000,000 but not over $1,250,000	$325,700, plus 39% of excess over $1,000,000.
Over $1,250,000 but not over $1,500,000	$423,200, plus 42% of excess over $1,250,000.

If the taxable estate is:	The tax shall be:
Over $1,500,000 but not over $2,000,000	$528,200, plus 45% of excess over $1,500,000.
Over $2,000,000 but not over $2,500,000	$753,200, plus 49% of excess over $2,000,000.
Over $2,500,000 but not over $3,000,000	$998,200, plus 53% of excess over $2,500,000.
Over $3,000,000 but not over $3,500,000	$1,263,200, plus 56% of excess over $3,000,000.
Over $3,500,000 but not over $4,000,000	$1,543,200, plus 59% of excess over $3,500,000.
Over $4,000,000 but not over $5,000,000	$1,838,200, plus 63% of excess over $4,000,000.
Over $5,000,000 but not over $6,000,000	$2,468,200, plus 67% of excess over $5,000,000.
Over $6,000,000 but not over $7,000,000	$3,138,200, plus 70% of excess over $6,000,000.
Over $7,000,000 but not over $8,000,000	$3,838,200, plus 73% of excess over $7,000,000.
Over $8,000,000 but not over $10,000,000	$4,568,200, plus 76% of excess over $8,000,000.
Over $10,000,000	$6,088,200, plus 77% of excess over $10,000,000.

SEC. 2002. LIABILITY FOR PAYMENT.

The tax imposed by this chapter shall be paid by the executor.

PART II—CREDITS AGAINST TAX

* * * * * * *

SEC. 2014. CREDIT FOR FOREIGN DEATH TAXES.

(a) IN GENERAL.—The tax imposed by section 2001 shall be credited with the amount of any estate, inheritance, legacy, or succession taxes actually paid to any foreign country in respect of any property situated within such foreign country and included in the gross estate (not including any such taxes paid with respect to the estate of a person other than the decedent). [If the decedent at the time of his death was not a citizen of the United States, credit shall not be allowed under this section unless the foreign country of which such decedent was a citizen or subject, in imposing such taxes, allows a similar credit in the case of a citizen of the United States resident in such country.] The determination of the country within which property is situated shall be made in accordance with the rules applicable under subchapter B (sec. 2101 and following) in determining whether property is situated within or without the United States.

(b) LIMITATIONS ON CREDIT.—The credit provided in this section with respect to such taxes paid to any foreign country—

(1) shall not, with respect to any such tax, exceed an amount which bears the same ratio to the amount of such tax actually paid to such foreign country as the value of property which is—

(A) situated within such foreign country,
(B) subjected to such tax, and
(C) included in the gross estate

bears to the value of all property subjected to such tax; and

(2) shall not, with respect to all such taxes, exceed an amount which bears the same ratio to the tax imposed by section 2001 (after deducting from such tax the credits provided by sections 2011 and 2012) as the value of property which is—

(A) situated within such foreign country,
(B) subjected to the taxes of such foreign country, and
(C) included in the gross estate

bears to the value of the entire gross estate reduced by the aggregate amount of the deductions allowed under sections 2055 and 2056.

(c) Valuation of Property.—

(1) The values referred to in the ratio stated in subsection (b)(1) are the values determined for purposes of the tax imposed by such foreign country.

(2) The values referred to in the ratio stated in subsection (b)(2) are the values determined under this chapter; but, in applying such ratio, the value of any property described in subparagraphs (A), (B), and (C) thereof shall be reduced by such amount as will properly reflect, in accordance with regulations prescribed by the Secretary or his delegate, the deductions allowed in respect of such property under sections 2055 and 2056 (relating to charitable and marital deductions).

(d) Proof of Credit.—The credit provided in this section shall be allowed only if the taxpayer establishes to the satisfaction of the Secretary or his delegate—

(1) the amount of taxes actually paid to the foreign country,
(2) the amount and date of each payment thereof,
(3) the description and value of the property in respect of which such taxes are imposed, and
(4) all other information necessary for the verification and computation of the credit.

(e) Period of Limitation.—The credit provided in this section shall be allowed only for such taxes as were actually paid and credit therefor claimed within 4 years after the filing of the return required by section 6018, except that—

(1) If a petition for redetermination of a deficiency has been filed with the Tax Court within the time prescribed in section 6213(a), then within such 4-year period or before the expiration of 60 days after the decision of the Tax Court becomes final.

(2) If, under section 6161, an extension of time has been granted for payment of the tax shown on the return, or of a

deficiency, then within such 4-year period or before the date of the expiration of the period of the extension.

Refund based on such credit may (despite the provisions of sections 6511 and 6512) be made if claim therefor is filed within the period above provided. Any such refund shall be made without interest.

(f) ADDITIONAL LIMITATION IN CASES INVOLVING A DEDUCTION UNDER SECTION 2053(d).—In any case where a deduction is allowed under section 2053(d) for an estate, succession, legacy, or inheritance tax imposed by and actually paid to any foreign country upon a transfer by the decedent for public, charitable or religious uses described in section 2055, the property described in subparagraphs (A), (B), and (C) of paragraphs (1) and (2) of subsection (b) of this section shall not include any property in respect of which such deduction is allowed under section 2053(d).

(g) POSSESSION OF UNITED STATES DEEMED A FOREIGN COUNTRY.—For purposes of the the credits authorized by this section, each possession of the United States shall be deemed to be a foreign country.

(h) SIMILAR CREDIT REQUIRED FOR CERTAIN ALIEN RESIDENTS.—Whenever the President finds that—

(1) a foreign country, in imposing estate, inheritance, legacy, or succession taxes, does not allow to citizens of the United States resident in such foreign country at the time of death a credit similar to the credit allowed under subsection (a),

(2) such foreign country, when requested by the United States to do so, has not acted to provide such a similar credit in the case of citizens of the United States resident in such foreign country at the time of death, and

(3) it is in the public interest to allow the credit under subsection (a) in the case of citizens or subjects of such foreign country only if it allows such a similar credit in the case of citizens of the United States resident in such foreign country at the time of death,

the President shall proclaim that, in the case of citizens or subjects of such foreign country dying while the proclamation remains in effect, the credit under subsection (a) shall be allowed only if such foreign country allows such a similar credit in the case of citizens of the United States resident in such foreign country at the time of death.

* * * * * * *

Subchapter B—Estates of Nonresidents Not Citizens

SEC. 2101. TAX IMPOSED.

[(a) IN GENERAL.—A tax computed in accordance with the table contained in section 2001 is hereby imposed on the transfer of the taxable estate, determined as provided in section 2106, of every decedent nonresident not a citizen of the United States dying after the date of enactment of this title.]

(a) RATE OF TAX.—Except as provided in section 2107, a tax computed in accordance with the following table is hereby imposed on the transfer of the taxable estate, determined as provided in section 2106, of every decedent nonresident not a citizen of the United States:

If the taxable estate is:	*The tax shall be:*
Not over $100,000	*5% of the taxable estate.*
Over $100,000 but not over $500,000	*$5,000, plus 10% of excess over $100,000.*
Over $500,000 but not over $1,000,000	*$45,000, plus 15% of excess over $500,000.*
Over $1,000,000 but not over $2,000,000	*$120,000, plus 20% of excess over $1,000,000.*
Over $2,000,000	*$320,000, plus 25% of excess over $2,000,000.*

(b) PROPERTY HELD BY ALIEN PROPERTY CUSTODIAN.—

For taxes in connection with property or interests transferred to or vested in the Alien Property Custodian, see section 36 of the Trading with the Enemy Act, as added by the Act of August 8, 1946 (60 Stat. 929; 50 U.S.C. App. 36).

SEC. 2102. CREDITS AGAINST TAX.

(a) IN GENERAL.—The tax imposed by section 2101 shall be credited with the amounts determined in accordance with sections 2011 to 2013, inclusive (relating to State death taxes, gift tax, and tax on prior transfers), *subject to the special limitation provided in subsection (b).*

(b) SPECIAL LIMITATION.—The maximum credit allowed under section 2011 against the tax imposed by section 2101 for State death taxes paid shall be an amount which bears the same ratio to the credit computed as provided in section 2011(b) as the value of the property, as determined for purposes of this chapter, upon which State death taxes were paid and which is included in the gross estate under section 2103 bears to the value of the total gross estate under section 2103. For purposes of this sub-

section, the term "State death taxes" means the taxes described in section 2011(a).

SEC. 2103. DEFINITION OF GROSS ESTATE.

For the purpose of the tax imposed by section 2101, the value of the gross estate of every decedent nonresident not a citizen of the United States shall be that part of his gross estate (determined as provided in section 2031) which at the time of his death is situated in the United States.

SEC. 2104. PROPERTY WITHIN THE UNITED STATES.

(a) STOCK IN CORPORATION.—For purposes of this subchapter shares of stock owned and held by a nonresident not a citizen of the United States shall be deemed property within the United States only if issued by a domestic corporation.

(b) REVOCABLE TRANSFERS AND TRANSFERS IN CONTEMPLATION OF DEATH.—For purposes of this subchapter, any property of which the decedent has made a transfer, by trust or otherwise, within the meaning of sections 2035 to 2038, inclusive, shall be deemed to be situated in the United States, if so situated either at the time of the transfer or at the time of the decedent's death.

(c) DEBT OBLIGATIONS.—For purposes of this subchapter, debt obligations of—

(1) a United States person, or

(2) the United States, a State or any political subdivision thereof, or the District of Columbia,

owned by a nonresident not a citizen of the United States shall be deemed property within the United States.

SEC. 2105. PROPERTY WITHOUT THE UNITED STATES.

(a) PROCEEDS OF LIFE INSURANCE.—For purposes of this subchapter, the amount receivable as insurance on the life of a nonresident not a citizen of the United States shall not be deemed property within the United States.

[(b) BANK DEPOSITS.—For purposes of this subchapter, any moneys deposited with any person carrying on the banking business, by or for a nonresident not a citizen of the United States who was not engaged in business in the United States at the time of his death shall not be deemed property within the United States.]

(b) DEPOSITS IN CERTAIN FOREIGN BRANCHES.—For purposes of this subchapter, deposits in a foreign branch of a domestic corporation, if such branch is engaged in the commercial banking business and if such deposits are payable only in foreign currency, shall not be deemed property within the United States.

(c) WORKS OF ART ON LOAN FOR EXHIBITION.—For purposes of this subchapter, works of art owned by a nonresident not a citizen of the United States shall not be deemed property within the United States if such works of art are—

(1) imported into the United States solely for exhibition purposes,

(2) loaned for such purposes, to a public gallery or museum, no part of the net earnings of which inures to the benefit of any private stockholder or individual, and

(3) at the time of the death of the owner, on exhibition, or en route to or from exhibition, in such a public gallery or museum.

SEC. 2106. TAXABLE ESTATE.

(a) DEFINITION OF TAXABLE ESTATE.—For purposes of the tax imposed by section 2101, the value of the taxable estate of every decedent nonresident not a citizen of the United States shall be determined by deducting from the value of that part of his gross estate which at the time of his death is situated in the United States—

(1) EXPENSES, LOSSES, INDEBTEDNESS, AND TAXES.—That proportion of the deductions specified in sections 2053 and 2054 (other than the deductions described in the following sentence) which the value of such part bears to the value of his entire gross estate, wherever situated. Any deduction allowable under section 2053 in the case of a claim against the estate which was founded on a promise or agreement but was not contracted for an adequate and full consideration in money or money's worth shall be allowable under this paragraph to the extent that it would be allowable as a deduction under paragraph (2) if such promise or agreement constituted a bequest.

(2) TRANSFERS FOR PUBLIC, CHARITABLE, AND RELIGIOUS USES.—

(A) IN GENERAL.—The amount of all bequests, legacies, devises, or transfers (including the interest which falls into any such bequest, legacy, devise, or transfer as a result of an irrevocable disclaimer of a bequest, legacy, devise, transfer, or power, if the disclaimer is made before the date prescribed for the filing of the estate tax return)—

(i) to or for the use of the United States, any State, Territory, any political subdivision thereof, or the District of Columbia, for exclusively public purposes;

(ii) to or for the use of any domestic corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art and the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation; or

(iii) to a trustee or trustees, or a fraternal society, order, or association operating under the lodge system, but only if such contributions or gifts are to be used within the United States by such trustee or trustees, or by such fraternal society, order, or association, exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, and no substantial part of the activities of such trustee or trustees, or of such fraternal society, order, or association, is carrying on propaganda, or otherwise attempting, to influence legislation.

(B) Powers of appointment.—Property includible in the decedent's gross estate under section 2041 (relating to powers of appointment) received by a donee described in this paragraph shall, for purposes of this paragraph, be considered a bequest of such decedent.

(C) Death taxes payable out of bequests.—If the tax imposed by section 2101, or any estate, succession, legacy, or inheritance taxes, are, either by the terms of the will, by the law of the jurisdiction under which the estate is administered, or by the law of the jurisdiction imposing the particular tax, payable in whole or in part out of the bequests, legacies, or devises otherwise deductible under this paragraph, then the amount deductible under this paragraph shall be the amount of such bequests, legacies, or devises reduced by the amount of such taxes.

(D) Limitation on deduction.—The amount of the deduction under this paragraph for any transfer shall not exceed the value of the transferred property required to be included in the gross estate.

(E) Disallowance of deductions in certain cases.—

For disallowance of certain charitable, etc., deductions otherwise allowable under this paragraph [section], see sections 503 and 681.

(F) Other cross references.—

(1) For option as to time for valuation for purpose of deduction under this paragraph [section], see section 2032.

(2) For exemption of bequests to or for benefit of Library of Congress, see section 5 of the Act of March 3, 1925, as amended (56 Stat. 765; 2 U.S.C. 161).

(3) For construction of bequests for benefit of the library of the Post Office Department as bequests to or for the use of the United States, see section 2 of the Act of August 8. 1946 (60 Stat. 924; 5 U.S.C. 393).

(4) For exemption of bequests for benefit of Office of Naval Records and Library, Navy Department, see section 2 of the Act of March 4, 1937 (50 Stat. 25; 5 U.S.C. 419b).

(5) For exemption of bequests to or for benefit of National Park Service, see section 5 of the Act of July 10, 1935 (49 Stat. 478; 16 U.S.C. 19c).

(6) For construction of devises or bequests accepted by the Secretary of State under the Foreign Service Act of 1946 as devises or bequests to or for the use of the United States, see section 1021 (e) of that Act (60 Stat. 1032; 22 U.S.C. 809).

(7) For construction of gifts or bequests of money accepted by the Attorney General for credit to "Commissary Funds, Federal Prisons" as gifts or bequests to or for the use of the United States, see section 2 of the Act of May 15, 1952, 66 Stat. 73, as amended by the Act of July 9, 1952, 66 Stat. 479 (31 U.S.C. 725s–4).

(8) For payment of tax on bequests of United States obligations to the United States, see section 24 of the Second Liberty Bond Act, as amended (59 Stat. 48, § 4; 31 U.S.C. 757e).

(9) For construction of bequests for benefit of or use in connection with the Naval Academy as bequests to or for the use of the United States, see section 3 of the Act of March 31, 1944 (58 Stat. 135; 34 U.S.C. 1115b).

(10) For exemption of bequests for benefit of Naval Academy Museum, see section 4 of the Act of March 26, 1938 (52 Stat. 119; 34 U.S.C. 1119).

(11) For exemption of bequests received by National Archives Trust Fund Board, see section 7 of the National Archives Trust Fund Board Act (55 Stat. 582; 44 U.S.C. 300gg).

(3) EXEMPTION.—

(A) GENERAL RULE.—An exemption of [$2,000] *$30,000.*

(B) RESIDENTS OF POSSESSIONS OF THE UNITED STATES.—In the case of a decedent who is considered to be a "nonresident not a citizen of the United States" under the provisions of section 2209, the exemption shall be the greater of (i) [$2,000] *$30,000,* or (ii) that proportion of the exemption authorized by section 2052 which the value of that part of the decedent's gross estate which at the time of his death is situated in the United States bears to the value of his entire gross estate wherever situated.

(b) CONDITION OF ALLOWANCE OF DEDUCTIONS.—No deduction shall be allowed under paragraphs (1) and (2) of subsection (a) in the case of a nonresident not a citizen of the United States unless the executor includes in the return required to be filed under section 6018 the value at the time of his death of that part of the gross estate of such nonresident not situated in the United States.

(c) UNITED STATES BONDS.—For purposes of section 2103, the value of the gross estate (determined as provided in section 2031) of a decedent who was not engaged in business in the United States at the time of his death—

(1) shall not include obligations issued by the United States before March 1, 1941; and

(2) shall include obligations issued by the United States on or after March 1, 1941.

SEC. 2107. EXPATRIATION TO AVOID TAX.

(a) RATE OF TAX.—A tax computed in accordance with the table contained in section 2001 is hereby imposed on the transfer of the taxable estate, determined as provided in section 2106, of every decedent nonresident not a citizen of the United States dying after the date of enactment of this section, if after March 8, 1965, and within the 10-year period ending with the date of death such decedent lost United States citizenship, unless such loss did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle A.

(b) GROSS ESTATE.—For purposes of the tax imposed by subsection (a), the value of the gross estate of every decedent to whom subsection (a) applies shall be determined as provided in section 2103, except that—

(1) if such decedent owned (within the meaning of section 958(a)) at the time of his death 10 percent or more of the total combined voting power of all classes of stock entitled to vote of a foreign corporation, and

(2) if such decedent owned (within the meaning of section 958(a)), or is considered to have owned (by applying the ownership rules of section 958(b)), at the time of his death, more than 50 percent of the total combined voting power of all classes of stock entitled to vote of such foreign corporation,

then that proportion of the fair market value of the stock of such foreign corporation owned (within the meaning of section 958(a)) by such decedent at the time of his death, which the fair market value of any assets owned by such foreign corporation and situated in the United States, at the time of his death, bears to the total fair market value of all assets owned by such foreign corporation at the time of his death, shall be included in the gross estate of such decedent. For purposes of the preceding sentence, a decedent shall be treated as owning stock of a foreign corporation at the time of his death if, at the time of a transfer, by trust or otherwise, within the meaning of sections 2035 to 2038, inclusive, he owned such stock.

(c) CREDITS.—The tax imposed by subsection (a) shall be credited with the amounts determined in accordance with sections 2011 to 2013, inclusive (relating to State death taxes, gift tax, and tax on prior transfers), as modified by section 2102(b).

(d) EXCEPTION FOR LOSS OF CITIZENSHIP FOR CERTAIN CAUSES.—Subsection (a) shall not apply to the transfer of the estate of a decedent whose loss of United States citizenship resulted from the application of section 301(b), 350, or 355 of the Immigration and Nationality Act, as amended (8 U.S.C. 1401(b), 1482, or 1487).

(e) BURDEN OF PROOF.—If the Secretary or his delegate establishes that it is reasonable to believe that an individual's loss of United States citizenship would, but for this section, result in a substantial reduction in the estate, inheritance, legacy, and succession taxes in respect of the transfer of his estate, the burden of proving that such loss of citizenship did not have for one of its principal purposes the avoidance of taxes under

this subtitle or subtitle A shall be on the executor of such individual's estate.

SEC. 2108. APPLICATION OF PRE-1966 ESTATE TAX PROVISIONS.

(a) IMPOSITION OF MORE BURDENSOME TAX BY FOREIGN COUNTRY.—Whenever the President finds that—

(1) under the laws of any foreign country, considering the tax system of such foreign country, a more burdensome tax is imposed by such foreign country on the transfer of estates of decedents who were citizens of the United States and not residents of such foreign country than the tax imposed by this subchapter on the transfer of estates of decedents who were residents of such foreign country,

(2) such foreign country, when requested by the United States to do so, has not acted to revise or reduce such tax so that it is no more burdensome than the tax imposed by this subchapter on the transfer of estates of decedents who were residents of such foreign country, and

(3) it is in the public interest to apply pre-1966 tax provisions in accordance with this section to the transfer of estates of decedents who were residents of such foreign country,

the President shall proclaim that the tax on the transfer of the estate of every decedent who was a resident of such foreign country at the time of his death shall, in the case of decedents dying after the date of such proclamation, be determined under this subchapter without regard to amendments made to sections 2101 (relating to tax imposed), 2102 (relating to credits against tax), and 6018 (relating to estate tax returns) on or after the date of enactment of this section.

(b) ALLEVIATION OF MORE BURDENSOME TAX.—Whenever the President finds that the laws of any foreign country with respect to which the President has made a proclamation under subsection (a) have been modified so that the tax on the transfer of estates of decedents who were citizens of the United States and not residents of such foreign country is no longer more burdensome than the tax imposed by this subchapter on the transfer of estates of decedents who were residents of such foreign country, he shall proclaim that the tax on the transfer of the estate of every decedent who was a resident of such foreign country at the time of his death shall, in the case of decedents dying after the date of such proclamation, be determined under this subchapter without regard to subsection (a).

(c) NOTIFICATION OF CONGRESS REQUIRED.—No proclamation shall be issued by the President pursuant to this section unless, at least 30 days prior to such proclamation, he has notified the Senate and the House of Representatives of his intention to issue such proclamation.

(d) IMPLEMENTATION BY REGULATIONS.—The Secretary or his delegate shall prescribe such regulations as may be necessary or appropriate to implement this section.

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CHAPTER 12—GIFT TAX

Subchapter A—Determination of Tax Liability

SEC. 2501. IMPOSITION OF TAX.

(a) *Taxable Transfers.*—

(*1*) General rule.—For the calendar year 1955 and each calendar year thereafter a tax, computed as provided in section 2502, is hereby imposed on the transfer of property by gift during such calendar year by any individual, resident or nonresident [except transfers].

(*2*) *Tranfers of intangible property.—Except as provided in paragraph (3), paragraph (1) shall not apply to the transfer* of intangible property by a nonresident not a citizen of the United States [who was not engaged in business in the United States during such calendar year].

(*3*) *Exceptions.—Paragraph (2) shall not apply in the case of a donor who at any time after March 8, 1965, and within the 10-year period ending with the date of transfer lost United States citizenship unless—*

(A) such donor's loss of United States citizenship resulted from the application of section 301(b), 350, or 355 of the Immigration and Nationality Act, as amended (8 U.S.C. 1401(b), 1482, or 1487), or

(B) such loss did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle A.

(*4*) *Burden of proof.—If the Secretary or his delegate establishes that it is reasonable to believe that an individual's loss of United States citizenship would, but for paragraph (3), result in a substantial reduction for the calendar year in the taxes on the transfer of property by gift, the burden of proving that such loss of citizenship did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle A shall be on such individual.*

(b) Certain Residents of Possessions Considered Citizens of the United States.—A donor who is a citizen of the United States and a resident of a possession thereof shall, for purposes of the tax imposed by this chapter, be considered a "citizen" of the United States within the meaning of that term wherever used in this title unless he acquired his United States citizenship solely by reason of

(1) his being a citizen of such possession of the United States, or (2) his birth or residence within such possession of the United States.

(c) CERTAIN RESIDENTS OF POSSESSIONS CONSIDERED NONRESIDENTS NOT CITIZENS OF THE UNITED STATES.—A donor who is a citizen of the United States and a resident of a possession thereof shall, for purposes of the tax imposed by this chapter, be considered a "nonresident not a citizen of the United States" within the meaning of that term wherever used in this title, but only if such donor acquired his United States citizenship solely by reason of (1) his being a citizen of such possession of the United States, or (2) his birth or residence within such possession of the United States.

(d) CROSS REFERENCES.—

(1) For increase in basis of property acquired by gift for gift tax paid, see section 1015(d).

(2) For exclusion of transfers of property outside the United States by a nonresident who is not a citizen of the United States, see section 2511(a).

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Subchapter B—Transfers

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SEC. 2511. TRANSFERS IN GENERAL.

(a) SCOPE.—Subject to the limitations contained in this chapter, the tax imposed by section 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible; but in the case of a nonresident not a citizen of the United States, shall apply to a transfer only if the property is situated within the United States.

[(b) STOCK IN CORPORATION.—Shares of stock owned and held by a nonresident not a citizen of the United States shall be deemed property within the United States only if issued by a domestic corporation.]

(b) INTANGIBLE PROPERTY.—For purposes of this chapter, in the case of a nonresident not a citizen of the United States who is excepted from the application of section 2501(a)(2)—

(1) shares of stock issued by a domestic corporation, and

(2) debt obligations of—

(A) a United States person, or

(B) the United States, a State or any political subdivision thereof, or the District of Columbia, which are owned by such nonresident shall be deemed to be property situated within the United States.

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CHAPTER 24—COLLECTION OF INCOME TAX AT SOURCE ON WAGES

SEC. 3401. DEFINITIONS.

(a) WAGES.—For purposes of this chapter, the term "wages" means all remuneration (other than fees paid to a public official) for services performed by an employee for his employer, including the cash value of all remuneration paid in any medium other than cash; except that such term shall not include remuneration paid—

(1) for active service as a member of the Armed Forces of the United States performed in a month for which such member is entitled to the benefits of section 112; or

(2) for agricultural labor (as defined in section 3121(g)); or

(3) for domestic service in a private home, local college club, or local chapter of a college fraternity or sorority; or

(4) for service not in the course of the employer's trade or business performed in any calendar quarter by an employee, unless the cash remuneration paid for such service is $50 or more and such service was performed by an individual who is regularly employed by such employer to perform such service. For purposes of this paragraph, an individual shall be deemed to be regularly employed by an employer during a calendar quarter only if—

(A) on each of some 24 days during such quarter such individual performs for such employer for some portion of the day service not in the course of the employer's trade or business; or

(B) such individual was regularly employed (as determined under subparagraph (A)) by such employer in the performance of such service during the preceding calendar quarter; or

(5) for services by a citizen or resident of the United States for a foreign government or an international organization; or

[(6) for services performed by a nonresident alien individual, other than—

[(A) a resident of a contiguous country who enters and leaves the United States at frequent intervals; or

[(B) a resident of Puerto Rico if such services are performed as an employee of the United States or any agency thereof; or

[(C) an individual who is temporarily present in the United States as a nonimmigrant under subparagraph (F) or (J) of section 101(a)(15) of the Immigration and Nationality Act, as amended, if such remuneration is exempt, under section 1441(c)(4)(B), from deduction and withholding under section 1441(a), and is not exempt from taxation under section 872(b)(3); or]

[(7)] *(6)* for such services, performed by a nonresident alien individual [who is a resident of a contiguous country and who enters and leaves the United States at frequent intervals], as may be designated by regulations prescribed by the Secretary or his delegate; or

(8)(A) for services for an employer (other than the United States or any agency thereof)—

(i) performed by a citizen of the United States if, at the time of the payment of such remuneration, it is reasonable to believe that such remuneration will be excluded from gross income under section 911; or

(ii) performed in a foreign country or in a possession of the United States by such a citizen if, at the time of the payment of such remuneration, the employer is required by the law of any foreign country or possession of the United States to withhold income tax upon such remuneration; or

(B) for services for an employer (other than the United States or any agency thereof) performed by a citizen of the United States within a possession of the United States (other than Puerto Rico), if it is reasonable to believe that at least 80 percent of the remuneration to be paid to the employee by such employer during the calendar year will be for such services; or

(C) for services for an employer (other than the United States or any agency thereof) performed by a citizen of the United States within Puerto Rico, if it is reasonable to believe that during the entire calendar year the employee will be a bona fide resident of Puerto Rico; or

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Subtitle F—Procedure and Administration

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CHAPTER 61—INFORMATION AND RETURNS

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Subchapter A—Returns and Records

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PART II—TAX RETURNS OR STATEMENTS

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Subpart B—Income Tax Returns

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SEC. 6015. DECLARATION OF ESTIMATED INCOME TAX BY INDIVIDUALS.

(a) REQUIREMENT OF DECLARATION.—[Every] *Except as otherwise provided in subsection (i), every* individual [(other than a nonresident alien with respect to whose wages, as defined in section 3401(a), withholding under chapter 24 is not made applicable, but including every alien individual who is a resident of Puerto Rico during the entire taxable year)] shall make a declaration of his estimated tax for the taxable year if—

(1) the gross income for the taxable year can reasonably be expected to exceed—

(A) $5,000, in the case of—

(i) a single individual other than a head of a household (as defined in section 1(b)(2)) or a surviving spouse (as defined in section 2(b));

(ii) a married individual not entitled under subsection (b) to file a joint declaration with his spouse; or

(iii) a married individual entitled under subsection (b) to file a joint declaration with his spouse, but only if the aggregate gross income of such individual and his spouse for the taxable year can reasonably be expected to exceed $10,000; or

(B) $10,000, in the case of—

(i) a head of a household (as defined in section 1(b)(2)); or

(ii) a surviving spouse (as defined in section 2(b)); or

(2) the gross income can reasonably be expected to include more than $200 from sources other than wages (as defined in section 3401 (a)).

Notwithstanding the provisions of this subsection, no declaration is required if the estimated tax (as defined in subsection (c)) can reasonably be expected to be less than $40.

(b) JOINT DECLARATION BY HUSBAND AND WIFE.—In the case of a husband and wife, a single declaration under this section may be made by them jointly, in which case the liability with respect to the estimated tax shall be joint and several. No joint declaration may be made if either the husband or the wife is a nonresident alien, if they are separated under a decree of divorce or of separate maintenance, or if they have different taxable years. If a joint declaration is made but a joint return is not made for the taxable year, the estimated tax for such year may be treated as the estimated tax of either the husband or the wife, or may be divided between them.

(c) ESTIMATED TAX.—For purposes of this title, in the case of an individual, the term "estimated tax" means the amount which the individual estimates as the amount of the income tax imposed by chapter 1 for the taxable year, minus the amount which the individual estimates as the sum of any credits against tax provided by part IV of subchapter A of chapter 1.

(d) CONTENTS OF DECLARATION.—The declaration shall contain such pertinent information as the Secretary or his delegate may by forms or regulations prescribe.

(e) AMENDMENT OF DECLARATION.—An individual may make amendments of a declaration filed during the taxable year under regulations prescribed by the Secretary or his delegate.

(f) RETURN AS DECLARATION OR AMENDMENT.—If on or before January 31 (or February 15, in the case of an individual referred to in section 6073(b), relating to income from farming or fishing) of the succeeding taxable year the taxpayer files a return, for the taxable year for which the declaration is required, and pays in full the amount computed on the return as payable, then, under regulations prescribed by the Secretary or his delegate—

(1) if the declaration is not required to be filed during the taxable year, but is required to be filed on or before January 15, such return shall be considered as such declaration; and

(2) if the tax shown on the return (reduced by the sum of the credits against tax provided by part IV of subchapter A of chapter 1) is greater than the estimated tax shown in a declaration previously made, or in the last amendment thereof, such return shall be considered as the amendment of the declaration permitted by subsection (e) to be filed on or before January 15.

In the application of this subsection in the case of a taxable year beginning on any date other than January 1, there shall be substituted, for the 15th or last day of the months specified in this subsection, the 15th or last day of the months which correspond thereto.

(g) SHORT TAXABLE YEARS.—An individual with a taxable year of less than 12 months shall make a declaration in accordance with regulations prescribed by the Secretary or his delegate.

(h) ESTATES AND TRUSTS.—The provisions of this section shall not apply to an estate or trust.

(i) NONRESIDENT ALIEN INDIVIDUALS.—No declaration shall be required to be made under this section by a nonresident alien individual unless—

(1) withholding under chapter 24 is made applicable to the wages, as defined in section 3401(a), of such individual,

(2) such individual has income which is effectively connected with the conduct of a trade or business within the United States, or

(3) such individual is a resident of Puerto Rico during the entire taxable year.

[(i)] *(j)* APPLICABILITY.—This section shall be applicable only with respect to taxable years beginning after December 31, 1954; and sections 58, 59, and 60 of the Internal Revenue Code of 1939 shall continue in force with respect to taxable years beginning before January 1, 1955.

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SEC. 6018. ESTATE TAX RETURNS.

(a) RETURNS BY EXECUTOR.—

(1) CITIZENS OR RESIDENTS.—In all cases where the gross estate at the death of a citizen or resident exceeds $60,000, the executor shall make a return with respect to the estate tax imposed by subtitle B.

(2) NONRESIDENTS NOT CITIZENS OF THE UNITED STATES.—In the case of the estate of every nonresident not a citizen of the United States if that part of the gross estate which is situated in the United States exceeds [$2,000] *$30,000*, the executor shall make a return with respect to the estate tax imposed by subtitle B.

(b) RETURNS BY BENEFICIARIES.—If the executor is unable to make a complete return as to any part of the gross estate of the decedent, he shall include in his return a description of such part and the name of every person holding a legal or beneficial interest therein. Upon notice from the Secretary or his delegate such person shall in like manner make a return as to such part of the gross estate.

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CHAPTER 79—DEFINITIONS

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SEC. 7701. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

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(31) FOREIGN ESTATE OR TRUST.—The terms "foreign estate" and "foreign trust" mean an estate or trust, as the case may be, the income of [which from] *which, from* sources without the [United States is] *United States which is not effectively connected with the conduct of a trade or business within the United States, is* not includible in gross income under subtitle A.

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WRITTEN STATEMENTS ON H.R. 11297, FOREIGN INVESTORS TAX ACT OF 1965

ALUMINUM CO. OF AMERICA,
Pittsburgh, Pa., February 14, 1966.

Hon. WILBUR D. MILLS,
Chairman, House Ways and Means Committee,
House Office Building, Washington, D.C.

DEAR CHAIRMAN MILLS: It is my understanding that your committee intends to consider in executive session on Wednesday, February 16, 1966, H.R. 11297 entitled "Foreign Investors Tax Act of 1965." We are most alarmed by what seems to be a fundamental change in U.S. concepts applicable to taxation of foreign corporations and foreign-earned income.

Under current law, a foreign corporation is subject to U.S. tax only where the corporation derives income from sources within the United States. The derivation of such income has heretofore been determined under the generally precise source rules in sections 861 through 863 of the Internal Revenue Code.

As now written, H.R. 11297 would radically depart from these established jurisdictional concepts and subject foreign corporations to U.S. tax on income which is "effectively connected" with the conduct of a trade or business within the United States. The question of when a foreign corporation "is engaged in business within the United States" is itself not easily answered. The subject bill would inject greater vagueness and uncertainty into this area of international business planning by adopting, as a jurisdictional principle of taxation, an entirely new, undefined and untested concept of "effective connection."

We are deeply concerned that such a radical change in the international aspects of our tax system is being considered. Accordingly, we strongly urge that this proposed language be deleted from H.R. 11297 or alternatively that further study be made of the feasibility and practicality of such a test, including the scheduling of public hearings.

Please let me know if I can be of any assistance to you in this matter.

Sincerely,

E. A. VAUGHN,
Vice President and Controller.

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THE AMERICAN BANKERS ASSOCIATION,
New York, N.Y., February 15, 1966.

Hon. WILBUR D. MILLS,
Chairman, House Ways and Means Committee,
Longworth House Office Building, Washington, D.C.

DEAR MR. MILLS: The American Bankers Association, on behalf of its member banks, is seriously concerned with certain provisions contained in H.R. 11297, a bill to amend the Internal Revenue Code of 1954 to provide equitable tax treatment for foreign investment in the United States, which is pending before your committee.

Section 2 of the bill would amend the Internal Revenue Code of 1954 and make interest on bank deposits received by a nonresident alien individual or a foreign corporation, if such interest is not effectively connected with the conduct of a trade or business within the United States, subject to U.S. income taxes for amounts paid or credited after December 31, 1970. Section 8(d) of the bill also amends the Internal Revenue Code of 1954 to treat bank deposits of nonresident aliens who are not engaged in business in the United States as property within the United States and thereby subject to U.S. estate taxes.

In our opinion, these changes in the present law which makes interest on U.S. bank deposits foreign source income when paid to persons not engaged in business in the United States, and which treats bank deposits of nonresident aliens not engaged in business in the United States as property without the United States for purposes of computing the estate taxes of such aliens, would adversely affect the ability of U.S. commercial banks to support international trade and would cause deterioration in the U.S. balance of payments and in our gold stock.

The overall purposes of H.R. 11297, as stated by the Committee on Ways and Means in its summary of the principal provisions of the bill, are "to modernize the present U.S. tax treatment of foreigners and to encourage foreign investment in the United States—thereby beneficially affecting the U.S. balance of payments—by removing tax barriers to such investment." These objectives are highly commendable. However, the provisions of the bill referred to above, as relates to commercial banking, would be self-defeating; since, in our view, they would cause an outflow of funds from the United States.

Deposits of private foreigners, which run into several billions of dollars, have given American banks resources for lending in support of international trade and development. Since bank liabilities to foreigners are greater than bank claims upon foreigners, it is clear that such deposits have further provided a means of financing the U.S. balance-of-payments deficit. Data of the Department of Commerce show increases in short-term dollar holdings of private foreigners (mostly deposits) since 1958 have helped finance the U.S. balance of payments on an average of $800 million a year. Repayment of these obligations would involve shifts into official dollar holdings that would be eligible for conversion into gold. A movement of this gold out of the United States would impose unwanted pressures internationally on our country.

The importance of retaining foreign bank deposits in this country from the standpoint of our balance of payments was considered an important factor by the Banking and Currency Committee in its report on H.R. 5306, 89th Congress, 1st session (Rept. 336), a bill to continue the authority of domestic banks to pay interest on time deposits of foreign governments at rates differing from those applicable to domestic depositors. The committee, in recommending passage of H.R. 5306, stated that "the object of the bill is to extend existing provisions of law designed to encourage foreign governments and monetary authorities to maintain dollar accounts in this country rather than convert these dollar accounts directly into gold or to transfer the funds to other financial centers, whereupon they could be acquired by official institutions of other countries and be converted into gold."

Bringing our international payments into balance is difficult, particularly in light of the present magnitude of U.S. Government commitments in support of world peace and development. As an emergency expedient, American businessmen and bankers have been enlisted in a voluntary program of restraints on U.S. capital outflow to eliminate the deficits. This effort should not be undermined by introducing penalties on foreign deposits with American banks. We should recall that the purpose of tax legislation in this area at this time is to create a more attractive climate for foreign investments in the United States. Even the threat of the contemplated action is harmful, affecting foreigners' decisions to open or maintain accounts with American banks.

Beyond balance-of-payments considerations, sharp reductions in dollar deposits from abroad would frustrate U.S. monetary policy. Deposits from foreigners exceed loans to foreigners. A significant portion of this margin is used for loans and investments in the United States. Thus, if deposits from foreigners are sharply curtailed, the domestic credit market would be placed under pressure. Although monetary authorities could, over time, alleviate this situation by adding to domestic bank reserves, sharp losses of foreign deposits would at best be disruptive to the domestic financial system. Sharp deposit losses would have a comparable impact on the international financial system.

It is recognized that the bill provides that the amendments made by it are not to apply where application would be contrary to any treaty obligation of the United States and that there is a 5-year period before the income tax would be effective on bank deposits. Nevertheless, legislation of this character is apt to have an unwholesome immediate effect on investor psychology and we can look to a prompt outflow of funds seeking investment outlets in other countries.

In conclusion, the foregoing mentioned amendments of the 1954 code, as proposed by H.R. 11297—

Would impair the ability of American banks to hold and to attract foreign demand and time balances.

Would have an adverse impact on the U.S. balance of payments and gold stock.

Would inject an unsettling element in domestic and world financial markets as deposits from foreigners were reduced.

Would discriminate against American businessmen and banks in their effort to obtain a fair share of international markets.

Would cast further doubt on the future value of the U.S. dollar.

We strongly urge that these provisions of H.R. 11297, as relates to commercial banks, be deleted, in the interests of the United States and international economies.

Very truly yours,

Archie K. Davis, *President.*

AMERICAN CYANAMID CO.,
February 15, 1966.

Hon. WILBUR D. MILLS,
Chairman, Committee on Ways and Means,
House Office Building:

With reference to H.R. 11297 which you introduced to remove tax barriers to foreign investment in the United States, we are concerned that its provisions may adversely affect foreign subsidiaries of U.S. corporations. Certain new and indefinite provisions have been incorporated in H.R. 11297 which were not present in its predecessor bill, H.R. 5916. In order to clarify the effect of this bill, particularly as it may apply tax to U.S. corporate interests, we urge that hearings be held on H.R. 11297 and request your support in this connection.

R. C. PLUMB.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS,
Los Angeles, Calif., January 12, 1966.

Hon. WILBUR D. MILLS,
Chairman, Ways and Means Committee,
Longworth House Office Building, Washington, D.C.

DEAR MR. MILLS: On September 28 you introduced H.R. 11297 to replace H.R. 5916 regarding foreign investment in the United States.

The institute's committee on Federal taxation has reviewed H.R. 11297 and submits for your committee's consideration the enclosed comments and recommendations on the bill. Our comments on H.R. 5916 were submitted to you on June 24, 1965.

There are a number of major differences between H.R. 11297 and H.R. 5916. As discussed in detail in our statement, we believe that four of these changes would tend to work against the bill's primary purpose that is, the removal of tax barriers to foreign investment in the United States. Moreover, these changes constitute such a major revision of the U.S. tax laws that we believe additional public hearings should be scheduled before your committee acts on H.R. 11297.

Under separate cover we are sending 40 additional copies of our comments to Mr. Leo H. Irwin, chief counsel.

Sincerely,

DONALD T. BURNS,
General Chairman, Committee on Federal Taxation.

COMMENTS AND RECOMMENDATIONS OF COMMITTEE ON FEDERAL TAXATION

GENERAL COMMENTS

H.R. 11297 is a modified version of an earlier bill, H.R. 5916. This committee finds that four modifications would tend to work against the bill's primary purpose, the removal of tax barriers to foreign investment in the United States. Further, these modifications constitute such a major revision of U.S. tax laws that additional public hearings would seem to be appropriate. The study which this committee has been able to devote to these changes suggests that they may have unintended and serious tax effects. The changes may also bring other adverse economic effects, particularly on the U.S. balance of payments.

The questionable changes which are proposed in H.R. 11297 are as follows:

(1) The introduction of an entirely new concept, that nonresident aliens and foreign corporations engaged in trade or business in the United States would be taxed on worldwide income "effectively connected" therewith. Current law taxes such persons on their U.S. source income only.

(2) After 1970, interest on U.S. bank deposits would be subject to U.S. tax although paid to persons not engaged in business here.

(3) U.S. bank deposits would be included in the gross estate of nonresident alien decedents even though not engaged in business in the United States.

(4) The bill imposes higher estate tax rates on nonresident alien decedents than those proposed in H.R. 5916.

The committee is aware of the need to evaluate other than balance-of-payments considerations in the preparation of such legislation, but the specific factors which led to the adoption of these changes have not been made clear. That the need for the changes is not immediately obvious is demonstrated by the fact that they were not proposed until very recently, although the kind of changes desirable with regard to U.S. taxation of foreign persons has been under continuous study since the formation of the Fowler task force in October 1963.

The changes cited above are discussed in some detail in items 1, 6, 9, and 10 of the attached "specific comments and recommendations." It is believed that the discussion makes clear the need for public hearings before the Committee on Ways and Means decides to recommend these major tax changes to the House of Representatives.

SPECIFIC COMMENTS AND RECOMMENDATIONS

Bill section 2: Proposed code section 861(a)(1) (A) and (D); 861(c)

(*1*) *Interest on U.S. bank deposits* (*p. 4, lines 9–14; p. 5, lines 1–18; p. 6, lines 3–6*).—The effect of the proposed amendments would be to subject interest on U.S. bank deposits and similar amounts to withholding of tax at source with respect to payments after December 31, 1970. There are two obvious reasons for questioning the proposed change:

(1) This exemption, which has been in force since 1921, has been considered desirable to encourage the use of U.S. banks by foreign persons for deposits and financial transactions.

(2) The nexus for such taxation of income from U.S. bank deposits is so slender as to raise doubts as to the rationale for the change.

While the effect of this change would be delayed for several years, it is not considered desirable because it creates another complication regarding investment in the United States. Such complications are believed to act as a current psychological deterrent to U.S. investment by nonresident aliens, even though the financial deterrent of U.S. withholding tax will not occur until 1971.

Another questionable change is the provision that the interest on deposits with foreign banking branches of U.S. corporations will be viewed as income from sources without the United States provided the deposit is in a foreign currency. After 1970 this provision will tend to force the deposit of the vast amounts of "Eurodollars" to be deposited with foreign banks in order to avoid U.S. taxation of the interest income.

Bill section 3: Proposed code section 871(a)

(2) *Subject of the tax on non-resident alien individuals (p. 13, line 15; p. 14, line 4).*—In proposed section 871(a), the words "gross income" should replace the words "amount received." In regulations section 1.871-7(b)(1) there is the following clarification: "For the purposes of section 871(a)(1) 'amount received' means 'gross income.' "

Bill section 3: Proposed code section 871(a)

(3) *Page 13, lines 17-19.*—This proposed subsection describes the kinds of income *not* connected with a U.S. business which shall be subject to tax at the rate of 30 percent. It repeats the enumeration of the types of income presently described in section 871(a)(1), including the words "salaries," "wages," "compensations," "remunerations," and "emoluments." Under proposed section 864(b) the performance of personal services within the United States will constitute engaging in a trade or business within the United States except under certain limited circumstances. Remunerations for such personal services, therefore, would be taxed at graduated rates under proposed section 871(b) as income effectively connected with the conduct of a trade or business within the United States. Accordingly, proposed section 871(a) should be revised to exclude the terms cited above which are descriptive of payments for personal services.

Bill section 3: Proposed code section 871(a)(2)

(4) *Conforming the phraseology applicable to gains and losses (p. 14, lines 15 and 16).*—The phrase used in lines 15 and 16, page 14, in reference to the word "losses" is: "allocable to sources within the United States." It would seem preferable to continue to use the phrase "derived from sources within the United States" as it is used in line 13 with reference to the word "gains."

Bill section 3: Proposed code section 871(a)(2)

(5) *Determination of capital gains of aliens present in the United States 183 days or more.*—It is assumed that the intent of the bill is to subject nonresident aliens who are present in the United States for 183 days or more during a year to a 30-percent rate of tax. This provision places such an alien in a disadvantageous position in comparison with a domestic investor, because under the provisions of lines 22-24, page 14, and lines 1-2, page 15, the alternative tax and capital loss carryover provisions are not to be allowed. This seems contrary to the intent of the bill. We recommend that the rate of tax be 25 percent and that consideration be given to allowing the deduction of capital loss carryovers.

Bill section 3: Proposed code sections 871(b) and 882

(6) *Income "effectively connected" with a U.S. trade or business (p. 15, lines 14-20, and p. 32, lines 8-14).*—It is proposed that non-

resident aliens and foreign corporations engaged in trade or business within the United States would be subject to regular rates of tax on *worldwide* income "effectively connected" with such trade or business. This is the most surprising change in the bill, as compared with H.R. 5916, because it represents a real innovation in U.S. taxation of foreign persons. Heretofore foreign corporations and nonresident alien individuals engaged in trade or business here have been subject to U.S. income tax only on U.S.-source income.

It has been said that the adoption of the "effectively connected" concept is in accord with the OECD model income tax convention and with our new treaty approach as evidenced by the recent protocol with Germany. Our study of these documents and of the reports of the Department of State and of the staff of the Joint Committee on Internal Revenue Taxation on the German protocol has disclosed no indication that foreign source income would be taxed. Article III of the convention with Germany as amended, dealing with the taxation of the industrial or commercial profits of an enterprise, does not even use the term "effectively connected" and article XV, dealing with the avoidance of double taxation, limits the allowable tax credits and/or exclusions from taxable income to income having its *source* in the other country.

We believe that enactment of H.R. 11297 could lead to serious problems of double taxation, particularly with regard to foreign subsidiaries of U.S. corporations. If such a foreign subsidiary were subjected to U.S. taxes under this principle, double taxation would result when the U.S. parent corporation receives dividends from the subsidiary since no credit is permitted for U.S. income taxes paid by a foreign corporation.

It is recognized that a motivating factor in this proposal to tax foreign persons engaged in trade or business in the United States on their worldwide income is concern that otherwise tax avoidance may be permitted. We do not believe that major tax avoidance does result under the existing provisions for taxation of such foreign persons. The Treasury has various ways of dealing with efforts to avoid U.S. income taxes, such as section 482, arrangements under various income tax treaties, and its ability to challenge such devices as the mere arrangement of title passage outside the United States for tax avoidance purposes.

The majority of our existing tax treaties contain provisions which limit the imposition of tax to income from sources within the taxing country. These include Australia, Austria, Denmark, Finland, Greece, Honduras, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Switzerland, and the United Kingdom. Since H.R. 11297 provides that the changes which it would make in U.S. tax law would not contravene any existing treaties, the treaties with the above-named countries would require amendment before the foreign source income of their corporations could be taxed by the United States.

The foreign tax credit proposed under new section 906 would not be allowed for taxes paid to a country solely by reason of the foreign person being domiciled there for tax purposes. This could result in double taxation where the country of domicile imposes limitations on allowable credits for foreign taxes which are similar to the U.S. rules. In such a case, where the U.S. taxes income which is derived from a third country, the country of domicile would not permit a foreign tax credit for the U.S. taxes paid on income derived from the third country.

Consideration should be given to defining more precisely the criteria given for the term "effectively connected" in section 864(c) (p. 12, lines 10–23). Otherwise, it is likely to discourage U.S. portfolio investment by foreign persons engaged in trade or business here, because in many cases they could not be sure of obtaining the generally lower rates of tax on investment income.

For the foregoing reasons we believe that it would be preferable to provide that a foreign corporation or a nonresident alien individual engaged in trade or business in the United States be taxed only on its *U.S.-source* income effectively connected with the U.S. trade or business.

We strongly urge that, if the Congress feels impelled to abandon the long-existing source of income rules in favor of this new and untried "effectively connected" concept, the committee reports should indicate clearly that the exercise by a U.S. corporation of management functions for a foreign subsidiary will not be considered to be the engagement in a trade or business within the United States by such foreign subsidiary. We also urge that code section 245 be amended to substitute the term "10 percent" wherever the term "50 percent" presently is used. This would permit a fractionalized dividends received credit in the majority of cases and would ameliorate, although not eliminate, the double taxation problems which we have described heretofore.

Bill section 4: Proposed code section 882(c)(2)

(7) *Softening of provision disallowing all deductions for failure to file a return (p. 33, line 21 through p. 34, line 8)*.—The disallowance of all deductions and most credits for failure to file a return under proposed section 882(c)(2), is an unusually harsh provision. Even though this provision is a part of the present law, the purposes of the bill would seem to indicate that the provision should be softened.

Bill section 6: Proposed code sections 901(c) and 2014(h)

(8) *Consistency in provisions requiring 30-day notice prior to Presidential proclamation (p. 53, line 17, and p. 54, line 19; cf. p. 48, line 3 and p. 63, line 25)*.—To be consistent with proposed sections 896 and 2108, proposed sections 901(c) and 2014(h) should require a 30-day notice to Congress before a proclamation is made by the President.

Bill section 8: Proposed code section 2101(a)

(9) *Rate of estate tax on nonresident alien decedents (p. 56, lines 21–23 and p. 57, lines 1–2)*.—The Fowler Task Force Report contained a recommendation to "eliminate U.S. estate taxes on all intangible personal property of nonresident alien decedents." We believe this recommendation should be followed. As pointed out in the report:

"Under existing U.S. tax law, a foreigner willing to go through the expense and trouble of establishing a personal holding company, incorporated abroad, and assuring himself that this personal holding company does not run afoul of the U.S. penalty taxes or undistributed personal holding company income, can already legally avoid estate taxes."

The possibility of using such a holding company would be made even easier due to a provision in the bill which would exempt from the personal holding company tax a foreign corporation if all of its stock is owned by foreigners.

Sophisticated investors may take advantage of this means of escaping estate tax; others will reject the complications and additional costs. It would seem preferable to enable both types of investors to acquire U.S. securities without concern for a substantial U.S. estate tax.

Bill section 8: Proposed code section 2105(b)

(10) *Inclusion of bank deposits in the gross estate (p. 58, lines 16–24)*.—The bill would remove the existing exemption from the gross estate for U.S. bank deposits owned by a nonresident alien decedent who was not engaged in business in the United States at the time of his death. This provision should be eliminated from the bill since, if enacted, it is likely to have an immediately adverse effect on the U.S. balance of payments.

The exclusion of bank deposits from the gross estate would also result from the adoption of the recommendation in item 9 above. In any event, as far as bank deposits are concerned, the proposed inclusion in the gross estate is clearly in the wrong direction.

THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK,
COMMITTEE ON TAXATION,
New York, January 19, 1966.

Hon. WILBUR D. MILLS,
Chairman, Ways and Means Committee of the House of Representatives, New House Office Building, Washington, D.C.

DEAR MR. MILLS: This committee has in preparation a report concerning H.R. 11297, the Foreign Investors Tax Act of 1965, which is critical of certain provisions of the bill. We hope to file the report with your committee within the next 10 days. We would appreciate notice of any hearings to be held on the bill.

Respectfully yours,

LAURENCE F. CASEY, *Chairman.*

COMMENTS ON H.R. 11297—FOREIGN INVESTORS TAX ACT OF 1965

Set forth below are the comments of the Committee on Taxation of the Association of the Bar of the City of New York on H.R. 11297.

According to the Ways and Means Committee's summary, a principal purpose of the bill is to encourage foreign investment in the United States—thereby beneficially affecting the U.S. balance of payments—by removing tax barriers to such investment. The committee believes that certain changes made under the bill will have precisely the contrary effect. For instance, the elimination of the income and estate tax exemptions relating to U.S. bank deposits must lead to withdrawals of substantial existing deposits from, and discourage potential deposits in, this country.

One further aspect of the bill may well serve to discourage investment in the United States. Under present law, it is possible to give fairly definite advice to a foreign corporation or partnership wishing to establish a branch in this country as to what part of its income will be treated as income from sources within the United States and subject to tax here. H.R. 11297 would abandon the use of these clearly defined "source" rules and instead subject to U.S. tax all income that is "effectively connected" with a U.S. branch operation. The "effectively connected" concept is vague and ill defined. To the extent that the bill substitutes an unclear standard of taxability for a clear one, making it more difficult for a foreign investor to determine what U.S. tax he will pay, it will, in the committee's opinion, serve to discourage investment in the United States.

Our detailed comments are submitted under six principal headings, as follows:

SOURCE OF INCOME

Section 2(a). Interest

The general effect of this provision is to extend the present exclusion of interest on bank deposits from U.S.-source income to interest paid by savings and loan associations and to interest paid on amounts held by an insurance company under an agreement to pay interest thereon. However, with one minor exception described below, the present exclusion of bank deposit interest from U.S.-source income as well as the proposed extension will terminate on December 31, 1970. Thus, all such interest paid or credited after December 31, 1970, will be subjected to a 30-percent withholding rate (or to any lower treaty withholding rate). It is believed that such change, even though deferred to 1970, will tend to discourage new deposits of substantial sums with U.S. banks, as well as encouraging the withdrawal of substantial deposits presently held by foreigners.

Section 2(a) of the bill adds a new subparagraph to the code excluding from "U.S. source income" interest paid on foreign currency deposits in foreign branches of U.S. banks, a change which is necessary because of the proposed termination of the present exclusion of bank interest from U.S. source income. This provision is desirable but should be extended to cover all interest paid by foreign branches of U.S. banks. If interest on dollar deposits in foreign branches of U.S. banks is subject to U.S. withholding taxes, such branches will be noncompetitive with local foreign banks. The resulting reduction in their earnings may tend to worsen the U.S. balance of payments. Should the above restriction induce the incorporation of their foreign branches by U.S. banks, the balance of payments may be further worsened by the accumulation of their earnings free of U.S. tax in such incorporated branches.

Section 2(b). Dividends from foreign corporations

This section modifies present code section 861(a)(2)(B) to provide that dividends from a foreign corporation are to be considered income from U.S. sources only if 80 percent of the corporation's gross income for the preceding 3-year period consisted of income effectively connected with the conduct of a trade or business within the United States. This change represents a marked liberalization of the present requirements for exclusion of dividends of foreign corporations from

U.S. source income and the committee questions the necessity therefor. Presumably the change is designed to eliminate the so-called second dividend tax, particularly with respect to investment income. However, where a foreign corporation is carrying on activities here which are effectively connected with a U.S. trade or business, there would seem to be no reason why the withholding tax should not apply. Accordingly, it is suggested that the present requirement be retained, or more appropriately, reduced below 50 percent.

In any event, in the interest of clarity, the word "total" should be added before the words "gross income" where they first appear in the subparagraph and the words "from all sources" should be added after the words "gross income." Since under the bill provisions (sec. 4(b)) amending section 882(b), the "gross income" of a foreign corporation would be limited to income from sources within the United States plus "effectively connected" income, section 861(a)(2)(B), as proposed, would produce an unintended result.

Section 2(c). Personal services

This provision desirably broadens the present exclusion from U.S. source income of the earnings of employees of (i) foreign corporations or (ii) foreign branches of U.S. corporations who earn less than $3,000 and are present here for less than 90 days, the exclusion being extended to employees of foreign offices of U.S. partnerships or individuals. No change has been made in the basic $3,000 exclusionary test. Since this figure has been part of the code at least since 1939 (and apparently has its genesis in sec. 201(c) of the Revenue Act of 1917), and since wage levels have increased materially in that period, consideration might be given to increasing this amount.

The exclusion presently applies to employees of foreign corporations, etc., where the employer is not engaged in trade or business in the United States if the employee is employed by a foreign office of the foreign employer. There would seem to be no basis for putting employees of a foreign branch of a foreign employer engaged in trade or business here in a worse position than that of employees of a foreign branch of a U.S. corporation. Section 861(a)(3)(C)(i) of the code and proposed section 864(b)(1)(A) should be amended to extend this exclusion to employees of a foreign branch of a foreign employer engaged in business in the United States.

Section 2(d): Definition of "trade or business within the United States"

Proposed code section 864(b)(2)(A) would provide that trading in stocks or securities through a resident broker custodian or other agent having discretionary authority would not constitute the carrying on of a trade or business within the United States. This is a desirable amendment which should aid in effectuating the purposes of the bill. The Treasury Department release of March 8, 1965, accompanying H.R. 5916, stated that no legislative change is necessary to provide that the volume of transactions is not material in determining whether an investor is engaged in trade or business in the United States since this is the rule under existing law. It is not believed that existing law in this regard is as clear as the Treasury release would indicate and it is therefore suggested that a specific clause be inserted in the proposed section 864(b)(2) affirmatively stating that the volume of securities or commodities transactions is not material in the determination of whether an investor is engaged in trade or business within the United States.

Income "effectively connected" with a U.S. trade or business

The bill actually utilizes the "effectively connected" concept for two purposes. First, the concept is used to determine whether dividends, interest, royalties, and other ordinarily "passive" types of income which are admittedly subject to U.S. tax are part of the income of a U.S. trade or business and properly subject to full rates of U.S. income tax or subject only to normally lower withholding tax rates. This use of the "effectively connected" concept parallels its use in the recent protocol to the United States-German Income Tax Convention and in the OECD Draft Double Taxation Convention. To this extent the use of the concept is proper and desirable, even recognizing the areas of question which underlie its interpretation. However, the bill then uses the "effectively connected" concept in a way in which it is not used in U.S. tax conventions or in the OECD draft. It is this second use of the concept which the committee believes represents a serious and undesirable departure from present law.

Under present law if a foreign corporation or nonresident alien is engaged in trade or business in the United States, then U.S. tax is imposed on the industrial and commercial income [1] of that trade or business to the extent that it is "from sources within the United States" (IRC secs. 872(a), 882(b)). The code and regulations contain fairly precise definitions of what is and is not income from sources within the United States and the case and other authority is now sufficiently clear so that definite answers can be given to the bulk of source of income questions arising in connection with industrial and commercial income. However, the bill would discard all of these established and well-understood rules and would treat as income of the foreign person's U.S. trade or business *all income* "effectively connected" with that trade or business without reference to its "source."

Proposed section 864(c) would provide a series of fairly amorphous "factors" which are to be "taken into account" in determining whether income is "effectively connected" with a U.S. trade or business. These "factors" provide no answers to the following everyday questions that will necessarily arise in applying the "effectively connected" concept. If goods are processed here and then shipped to a foreign country where they are sold through stores, with the benefit of extensive advertising, what part of the profit on sale is "effectively connected" with the trade or business carried on in the United States? What portion of the income from a sale of goods is effectively connected with the U.S. trade or business if goods are processed both here and abroad and then sold abroad? Suppose that the foreign corporation holds foreign patents, without which goods manufactured here could not be sold abroad. Does this affect the amount of income "effectively connected" with the U.S. trade or business? Suppose that a foreign corporation managed in this country operates oilfields throughout the world. What portion of its income is "effectively connected" with its U.S. trade or business?

[1] The code does not use the term "industrial or commercial income." The term as used here provides a convenient description of the types of income which will be affected by this change in present law.

There would seem to be only two alternative solutions in each of the foregoing cases. Either the entire income from the entire industrial and commercial income producing activity here and abroad is subject to U.S. tax or only part is so subject. If it is intended to subject all of such income to tax, this certainly represents a drastic and questionable change in our tax system. If only part of the income from the entire profitmaking activity is subject to U.S. tax then "source" rules will have to be provided and the bill simply becomes a vehicle for the rewriting of the source of income rules; and if this is what is intended, the rules should be set forth specifically in the bill and should not be left to committee reports or "guidelines."

The committee believes that this second and novel use of the "effectively connected" concept should not be adopted. Well-defined principles provided by the present source rules should be retained for purposes of determining what part of the industrial or commercial profits of a foreign person engaged in trade or business in the United States are to be taxed by the United States. This can be done by adding the words "from sources within the United States" after the words "gross income" in proposed section 882(b)(2) and after the words "gross income" the second time that they appear in proposed section 872(a)(2). Similar changes would be required in other provisions of the bill where the "effectively connected" phrasing appears.

Adoption of the "effectively connected" concept will mean the imposition of U.S. taxes on income of foreign corporations not presently subject thereto; and as this occurs, the risk of double taxation of the same income will increase notwithstanding the foreign tax credit and extension thereof proposed in section 6 of the bill. This provision would allow to foreign taxpayers engaged in trade or business in the United States a credit not presently allowed for foreign taxes imposed upon income "effectively connected" with the U.S. trade or business. The credit would not be allowed with respect to taxes which would not be imposed by the foreign jurisdiction but for the fact that the taxpayer was a citizen or resident of such country or was incorporated in that country. The committee believes that it will be extremely difficult in many cases for taxpayers to demonstrate that a particular tax would not have been assessed but for the fact of the taxpayer's citizenship, residence, or incorporation in the foreign jurisdiction.

Nonresident aliens

Section 3 would establish new rules for the application of the income tax to nonresident aliens.

1. The committee believes that the following substantive changes are sound and are appropriately carried out by the proposed bill.

(*a*) Nonresident aliens would be taxed separately on income effectively connected with a U.S. trade or business and income not so connected. Under the proposed bill, income not effectively connected with U.S. trade or business will be taxed at a 30-percent rate (or at a lower treaty rate, if applicable), and income which is effectively connected with a U.S. trade or business will be taxed at the regular graduated rate applicable to individuals. Under present law, the graduated rates apply only if nonresident aliens are engaged in trade or business in the United States or if their income exceeds $21,200.

(*b*) A nonresident alien is not to be subject to U.S. tax on capital gains unless he is here for more than 183 days during the year or unless such gains are effectively connected with a U.S. business.

(*c*) Every nonresident alien, irrespective of whether he is engaged in business here, may elect to treat certain real property and mineral income as connected with a business in order to obtain deductions (such as depreciation and depletion) attributable to such income.

2. A major change proposed by the bill is that, in determining the taxation of a nonresident alien engaged in business here, an alien is to be taxed on his taxable income which is effectively connected with the trade or business conducted in the United States. While precise rules are not spelled out, it appears that the concept is intended to be broader than the present concept of gross income from U.S. sources. For the reasons stated in the discussion of section 2 of the bill, it is believed that this change is inadvisable.

3. The withholding rules are amended to eliminate withholding on any item of income (other than compensation for personal services) which is effectively connected with conduct of a trade or business in the United States. It is believed that withholding should continue to be governed by the source of income rules, as these provide a much more objective and practicable standard for a withholding agent. At least, withholding should continue to be required with respect to dividends and interest. Under the proposed changes, there would be too great an incentive for persons to file false information with the withholding agent.

4. The definition of periodic income from U.S. sources (income subject to 30 percent tax) would be expanded to include income from the sale or liquidation of a collapsible corporation (sec. 341) and from original issue discount (sec. 1232). The committee believes that this extension of the definition of "periodic income" is inadvisable. The change would not result in any appreciable increase in tax collections, since the tax could easily be avoided by selling outside of the United States. Since it is sometimes difficult to know whether or not section 341 or section 1232 is applicable in the first instance, this expansion would tend to increase the uncertainty of taxation of nonresident aliens, which the proposed bill is supposedly designed to reduce.

5. As noted above, a nonresident alien may elect to treat income from certain real property as connected with a business in order to obtain the benefit of deductions attributable to such income. This election is equally applicable to a foreign corporation and the following comments are pertinent both to the election available to a nonresident alien individual and the election available to a foreign corporation.

The committee recommends that the election be extended to include personal property "associated" with the real property involved. For example, if a nonresident makes the election with regard to a hotel subject to a net lease, such election would also relate to all personal property in the hotel subject to the lease, so that the nonresident would not have one rule applying to the hotel lease and another rule applying to the lease of the personalty associated with the hotel. Also, it is not clear whether the election would extend to interest from mortgages on real property. Under the various tax conventions mortgage interest, more often than not, is specifically excluded from the concept of "income from real property." It is therefore recommended that proposed section 871(d)(A) be amended to make it clear that interest from mortgages on real property is not "income from real property." A similar change should be made in proposed section 882(d).

Proposed sections 873(a) and 882(c)(1)(A), in providing for the allowance of deductions and credits in respect of U.S. income, limit the deductions to circumstances in which they are "effectively connected with the conduct of a trade or business within the United States." It is recommended that these proposed sections be changed by inserting "attributable to income which is" immediately preceding the phrase quoted in the preceding sentence, so that it is clear when an election is made to treat real property income as income connected with a U.S. business that such election effectively permits the nonresident to obtain the offsetting deductions, the purpose of the election in the first instance.

Finally, the committee questions whether the election under sections 871(d) and 882(d) should extend to gains described in present code section 631 (b) or (c). Since such gains are also defined as periodic income, it would appear that a nonresident individual or corporation would always make the election in order to obtain a lower effective tax rate and possible use of such deductions against other business income.

Foreign corporations

Under section 4, a foreign corporation engaged in trade or business in the United States, like a nonresident alien similarly so engaged, would be taxed as if it were a resident on its taxable income which is effectively connected with the trade or business conducted here. Again, it appears that the concept of "effectively connected with the trade or business" is intended to be broader than the present concept of gross income from U.S. sources. For the reasons stated in the discussion of section 2 of the bill, it is believed that this change is inadvisable.

Section 4(a). Tax on income not connected with U.S. business

The title suggested for proposed code section 881, "Income of Foreign Corporations Not Connected With U.S. Business," fails to indicate, as it should, that a tax is imposed by that section. Accordingly, it is recommended that the section's title be amended by the addition of "Tax on" at the beginning thereof.

Proposed section 881(a)(1), reflecting changes made in proposed section 861(a)(1)(A), would eliminate from the category of nontaxable interest, interest on deposits with persons carrying on the banking business. For the reasons stated in the discussion of section 2(a) of the bill, it is believed that this change is inconsistent with the purpose of the bill to encourage foreigners to invest in the United States.

Proposed section 881(a) also would expand the definition of periodic income from U.S. sources (income subject to 30 percent tax) to include income from the sale or liquidation of a collapsible corporation (sec. 341) and from original issue discount (sec. 1232). For reasons stated in the discussion of section 3 of the bill, it is believed this extension of the definition of "periodic income" is inadvisable.

Section 4(b). Tax on income connected with U.S. business

It is recommended that the title to proposed section 882 be changed by adding at the beginning thereof the words "Tax on." It is recommended that subsection (a) of proposed section 882 be changed to read as follows:

"(a) Imposition of tax—A foreign corporation engaged in trade or business within the United States during the taxable year (or during any preceding taxable year beginning after December 31, 1965) shall be taxable as provided in section 11 or 1201(a) on its taxable income determined on the basis of its gross income as described in subsection (b)(2)."

The caption, "Imposition of Tax," would be consistent with the caption to proposed section 881(a) and the intended limitation of taxable income can be accomplished without a separate paragraph.

Proposed section 882(c)(1)(A), in providing for allowance of deductions and credits in respect of U.S. business income, limits the deductions to circumstances in which they are "effectively connected with the conduct of a trade or business within the United States." For reasons already given in respect of the similar provision affecting nonresident alien individuals in section 3 of the bill, it is recommended that the proposed section 882(c)(1)(A) be changed by inserting "attributable to income" immediately preceding the phrase quoted in the preceding sentence.

Proposed section 882(d)(1)(A) permits a foreign corporation to treat gains described in present code section 631 (b) or (c) as income connected with a U.S. business. For reasons stated in the discussion of section 3, in respect of the similar election granted to nonresident aliens, it is believed that this election in respect of section 631 (b) or (c) income is not desirable.

Proposed section 882(e) would seem to prohibit a direct filing of a return by a foreign corporation in the circumstances there described. It is recommended that, in order to assure that the foreign corporation may itself file the return, the words "unless such return is made by such foreign corporation" be added at the end of the sentence.

The withholding rules are amended to eliminate withholding on any item of income (other than compensation for personal services) which is effectively connected with the conduct of a trade or business in the United States. As stated in respect of section 3 of the bill it is believed that withholding should continue to be governed by the source of income rules.

Section 4(b)(3) of the bill, containing proposed changes in the table of sections for subpart B of part II of subchapter N of chapter 1, should be changed to reflect the above-recommended changes in the titles to sections 881 and 882. Thus, the words "Tax on" should be inserted at the beginning of the titles given for sections 881 and 882.

Section 4(d). Dividends received from certain foreign corporations

It is recommended that the amendment of section 245(a) of the code, as proposed in section 4(d)(1) of the bill, be changed by adding "total" before "gross income." Compare present code section 542(c)(7)(A). The addition of "total" would seem to negate any argument that the various statutory exclusions applicable to gross income of foreign corporations, see, for example, present code section 883, should be taken into account in determining gross income for this purpose.

Section 4(f). Corporations subject to personal holding company tax

The proposed section 542(c) would change the present rule for excluding certain foreign corporations from classification as a personal holding company. Under the proposed rule indirect ownership by nonresident alien individuals through foreign estates, foreign trusts, foreign partnerships as well as through other foreign corporations would be taken into account. It is unclear why attribution through partnerships is limited to foreign partnerships. It is recommended that the word "foreign" immediately preceding "partnerships" be deleted.

Section 4(g). Foreign corporations carrying on insurance business in the United States

It is recommended that the title to proposed section 842 be changed by adding at the beginning thereof the words "Tax on." A corresponding change would be required in paragraph (2) of section 4(g) of the bill, which would amend the table of sections for part IV of subchapter L of chapter 1 of the code.

Estate and gift taxes

The task force recommended the elimination of the Federal estate tax on intangible property of nonresident alien decedents. It is widely believed that the estate tax is a significant deterrent to foreign investment in U.S. securities. Nonetheless, the Treasury decision in presenting H.R. 5916 to retain an estate tax with relatively large exemption ($30,000) and with relatively low rates (a maximum of 15 percent and only 5 percent on the first taxable $100,000) was probably warranted. The committee takes no position regarding the desirability, from the standpoint of encouraging U.S. investments, of the proposed maximum 25 percent rate instead of the 15 percent maximum rate proposed in H.R. 5916.

Section 8(b) would provide a new technical limitation on the credit for State death taxes. Though arguments can be made as to a limitation keyed to the kind of limitation that a domiciliary of the United States might have, in the context of a bill designed to reassure foreigners with respect to the low impact of death duties in this country, the introduction of any such limitation seems undesirable. In addition, the limitation may operate somewhat unevenly depending upon how many intangible assets the decedent had which were not assignable to any State of the United States.

Section 8(c) would amend section 2104 to make it clear that where a debt obligation of a U.S. obligor is owned by a nonresident alien, the obligation shall be treated as property within the United States no matter where it is located. However, it should also be made clear that a foreign obligation physically located in the United States will not be treated as property within the United States, a result which would be only a logical extension of the proposal with respect to U.S. obligations. The same comment can be made respecting section 9(b) which would amend section 2511(b) to set forth similar situs rules in the gift tax area.

Expatriation

Sections 3(e), 8(f), and 9(a) contain alternative provisions designed to penalize for income, estate, and gift tax purposes certain persons who surrender their U.S. citizenship for the purpose of reducing their U.S. taxes. The Task Force on Promoting Increased Foreign Investments did not recommend such penalties and it may be questioned whether, on the one hand, the position of nonresident aliens is so greatly improved by the bill that U.S. citizens not otherwise prompted to expatriate themselves for tax reasons will now be induced to do so or, on the other hand, whether the penalties themselves are severe enough to prevent significant tax advantage from being gained for such surrender—as to justify adding these complexities and uncertainties to an already overburdened code. How, for example, can the Commissioner, with any semblance of uniformity of treatment, proceed to establish that "it is reasonable to believe" that an expatriate would have gained, but for proposed section 877, a "substantial" reduction of taxes on "probable income" for the year? In the case of estate tax on expatriates, would the "substantial" reduction in taxes be computed by reference to assets owned at expatriation or those owned at death, possibly 10 years later? Enforcement of such a provision can hardly be uniform; and lack of uniformity is further suggested in the exception provided for cases of dual citizenship. Moreover, it seems questionable whether, from a national policy standpoint, the United States should undertake such measures against persons willing to surrender their citizenship.

Section 3(e). Expatriation to avoid tax

It is recommended that the title of proposed section 877 be changed to "Tax on Certain Expatriates." Compare titles of other sections in part II of subchapter N of chapter 1, particularly sections 871, 881, and 882.

The clause starting with "if the tax" in the last two lines of subsection (a) of section 877 should be changed to read as follows: "if the tax for the taxable year computed pursuant to such subsection exceeds the tax for the taxable year computed without regard to this section."

In making computations to determine the applicability of an alternative tax it would not seem appropriate to speak of a "tax imposed." See, e.g., section 1341(a) of the code.

In the second line of subsection (c)(1) of proposed section 877, "debt obligations" (in the title and text) should be changed to "evidences of indebtedness," in order to conform to the terminology used in other areas of the code, e.g., sections 164 and 1232.

Section 8(f). Special methods of computing estate tax

It is recommended that the title of section 2107 be changed to "Tax on Estates of Certain Expatriates."

Section 9(b). Gift tax transfers

In subsection (b)(2) of section 2511 "debt obligations" should be changed to read "evidences of indebtedness".

BAKER, MCKENZIE & HIGHTOWER,
ATTORNEYS AT LAW,
Washington, D.C., February 11, 1966.

Re H.R. 11297—"Effectively connected" and certain partnerships.

Dr. LAURENCE N. WOODWORTH,
Chief of Staff, Joint Committee on Internal Revenue Taxation, Washington, D.C.

DEAR DR. WOODWORTH: This is to call your attention to a possible unintended repeal of a basic partnership rule by the "effectively connected" income concept proposed by H.R. 11297.

The problem involves U.S. partnerships with branch offices in various foreign countries. A number of large accounting and law partnerships exemplify the situation. The partners in many of the foreign offices of these partnerships are nonresident aliens. As you know, under the provisions of section 704(a) and section 702(a)(8), and the regulations thereunder, the partners by the terms of their partnership agreement can provide that the distributive share of the nonresident alien partners is to be derived from the income earned in their respective foreign countries. The effect of such provision, of course, is to establish that such partnership income does not have its source in the United States and accordingly is not subject to taxation by the United States. This well-settled rule of partnership law is in accord with the basic objectives of subchapter K.

In its present form, in the absence of a committee report explanation, it is possible to construe the definition of "effectively connected" income contained in proposed section 864(c) in H.R. 11297 as abrogating the foregoing rule of subchapter K. The problem is created by the following language of proposed section 864(c):

> "For purposes of this title, factors to be taken into account to determine whether gains, profits, and income or loss shall be treated as 'effectively connected' with the conduct of a trade or business in the United States by a non-resident alien individual or foreign corporation include whether—
>
> * * * * * * *
>
> (2) the gains, profits, and income or loss are accounted for through such trade or business * * *."

I am aware that at least one partnership maintains a centralized system of bookkeeping whereby the income and expenditures of its various foreign branches are recorded and the overall operation of the firm coordinated. The broad language of the statute, i.e., whether income is "accounted for through such trade or business," could conceivably result in subjecting the foreign source income of the nonresident alien partners of such partnership to Federal income taxation. Clearly, such a result does not appear to be the objective of H.R. 11297. And, of course, the statute merely lists a number of factors which are to be taken into account and does not state that the existence of one or all of these factors necessarily leads to the conclusion that the income has been effectively connected with a U.S. trade or business. Nevertheless, there is sufficient basis in the statute to warrant serious concern on the part of partners who might be affected by such a possible construction of the law. It is the purpose of this letter to urge that the committee make it clear either in the statute or in its report that subchapter K rules above outlined are in no way affected by H.R. 11297.

I shall, of course, be glad to expand on this matter or supply you with any additional information you may like to have.

Thank you in advance for your consideration of this matter.

Sincerely yours,

MICHAEL WARIS, Jr., Esq.

BANKERS' ASSOCIATION FOR FOREIGN TRADE,
Chicago, Ill., February 8, 1966.

Hon. WILBUR D. MILLS,
Chairman, House Ways and Means Committee,
House Office Building, Washington, D.C.

DEAR MR. MILLS: The board of directors of the Bankers' Association for Foreign Trade has asked me to record with you our most serious reservations regarding certain portions of the proposed Foreign Investors Tax Act, H.R. 11297, the stated purpose of which is to encourage foreign investments in the United States.

We recognize and applaud those provisions in the bill which will encourage overseas investment in our country. However, we are particularly concerned with the effect of section 861 (effective after December 31, 1970) which would treat as taxable income interest paid by U.S. banks and their overseas branches on deposits of nonresident alien individuals or foreign corporations, and section 2105 (effective upon enactment) which would treat as part of the taxable estates of nonresident alien individuals dollar deposits with American banks and their foreign branches.

We submit that it is untimely to propose additional taxes on foreign dollar deposits when we so urgently need these funds to support loans which finance our domestic and international trade and particularly at a time when we should be encouraging overseas holders of dollars to continue to invest them here to support our balance-of-payments efforts.

The American banking system must compete with foreign banks throughout the world for U.S. dollar deposits. Increased tax burdens on such deposits will only encourage overseas holders of dollar balances to transfer them to foreign banks overseas or to convert them to other currencies to eventually become a drain on our gold reserves.

Even though the proposed tax in section 861 will not become effective until 1971, its enactment would have an unsettling interim effect on the international money markets and we see no worthy purpose to be served by passing legislation now which attempts to anticipate conditions 5 years hence.

The effectiveness of American banks to compete with foreign banks for dollar deposits can only be impaired by the imposition of new taxes now and the prospects of increased taxes in the future. The unfavorable impact on the U.S. balance of payments and the adverse effect on money markets both in the United States and abroad are not warranted by the modest revenue these taxes would produce.

We strongly urge that sections 861 and 2105 be eliminated from H.R. 11297.

Respectfully yours,

G. E. KEIDEL, *President.*

CHICAGO, ILL.,
December 23, 1965.

Hon. WILBUR D. MILLS,
Ways and Means Committee,
House of Representatives,
Washington, D.C.

DEAR MR. MILLS: I am advised that H.R. 11297 provides that foreign corporations be taxed in the United States on their worldwide income in any way "effectively connected" with the conduct of a trade or business in the United States. As the chairman of your committee for some years, I am virtually certain that you are aware that the discrimination and identification of various species and sources of income have for about 45 years rested on the little words "derived from sources within the United States" and "derived from sources without the United States": These phrases have undergone the refinement and the gloss of scores of Treasury rulings and court cases, and have come to have such significance and meaning as to give some certainty and definition to the law. In fact, there are few phrases in the code which are by this time better known, more lucid in their present interpretation and more of a stabilizing force for the proper respecting and understnading of the law applicable.

The words "effectively connected" have no meaning in tax history, either by analogy or precedent: They inject novelty, uncertainty and ambiguity into an area otherwise orderly and sound. As a student and worker in the foreign tax-foreign operations field for some 15 years, I respectfully urge that this new bill be considered at very great length before permitting the eradication of those other sections of the law which have served so well for decades to accurately identify the sources of virtually all forms of income. I realize that the argument will be made that the superaddition of the words "effectively connected" do not destroy the meaning of the old source tests: I submit to you that the source tests have already been established effectively and responsibly, and that instead of adding to their existing vigor, the new words destroy their meaning.

Yours sincerely,

ANDREW W. BRAINERD, Esq.

BRISTOL-MYERS CO.,
New York, N.Y., February 15, 1966.

Re H.R. 11297, Foreign Investor's Tax Act of 1965.

Hon. WILBUR D. MILLS,
House of Representatives,
Washington, D.C.

SIR: H.R. 11297 introduces a new concept into the Internal Revenue Code; namely, that foreign corporations engaged in trade or business in the United States would be taxed on worldwide income "effectively connected" therewith. Heretofore foreign corporations engaged in trade or business in the United States have been subject to U.S. income tax only on U.S. source income.

Because the term "effectively connected" is a brandnew term having vast implications to companies such as ours with worldwide foreign operations, we earnestly request that you hold public hearings on this bill.

Very truly yours,

AUGUSTUS W. KELLEY,
Vice President and Tax Counsel.

CHRYSLER CORP.,
February 23, 1966.

Subject: H.R. 11297—The Foreign Investor's Tax Act.

Hon. WILBUR D. MILLS,
Chairman, House Ways and Means Committee,
Washington, D.C.

DEAR CONGRESSMAN MILLS: Several of the provisions of H.R. 11297 have come to our attention, which provisions, after careful study, we respectfully request be amended as follows:

I. That section 8(c) be amended by adding at the end thereof the following new subsection:

"(3) For purposes of this section, the term 'debt obligation' shall not include the debt obligation of a United States person, as defined in section 4920(a)(4), which derives less than 20 percent of the gross income from sources outside the United States for the 3-year period immediately preceding the close of its taxable year or for such part of such period as may be applicable."

This amendment would facilitate the obtaining of funds abroad by U.S. businesses for their overseas capital requirements.

II. That the following language of proposed sections 881 and 882 "effectively connected with the conduct of a trade or business within the United States" be deleted and that the present language in such sections be restored.

The proposed new language, "effectively connected," is too vague and uncertain and would compound the uncertainty and confusion already caused by section 482. The present rules are precise and permit taxpayers to know the source of their income. In competitive business dealings, it is important for companies to know what countries are going to tax their income.

Your consideration of the above recommendations will be deeply appreciated.

Yours very truly,

BRIAN T. O'KEEFE,
Manager, Tax Department.

CLARK EQUIPMENT CO.,
Buchanan, Mich., February 21, 1966.

Re House bill 11297.

Hon. WILBUR D. MILLS,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

MY DEAR MR. MILLS: It is our opinion that this bill, at is is written today, will create some very serious problems for American industry if it is allowed to become law. We object to the bill not only for tax reasons, as it might affect our company, but also because we do not believe that it will have the desired beneficial effect on the balance of payments or make investment in the United States more appealing to foreign investors.

The language of House bill H.R. 11297 is so vague that it is difficult to determine what it means and what it will accomplish. Yet, at the same time the language is so broad in application, that a reasonable interpretation of it indicates that the "effectively connected" principle could result in inequitable taxation of foreign income earned outside the United States by foreign manufacturing subsidiaries of U.S. corporations. In other words, double taxation of income could easily result from the provisions of this bill.

We respectfully request that public hearings be held so that the true significance and possible impact of the provisions of H.R. 11297 will become clear to you before you formally act on the administration's request that the bill be passed by Congress.

Sincerely yours,

R. F. SUMERWELL, *Tax Manager.*

CONTINENTAL ILLINOIS NATIONAL BANK
& TRUST CO. OF CHICAGO,
OFFICE OF CHAIRMAN OF THE BOARD,
Chicago, Ill., January 19, 1966.

Hon. WILBUR D. MILLS,
House of Representatives,
Washington, D.C.

DEAR MR. MILLS: The Foreign Investors Tax Act of 1965 (H.R. 11297) which has recently been referred to the Committee on Ways and Means contains a number of desirable provisions designed to promote foreign investment in the United States by removing tax barriers. It is regrettable that the bill also proposes changes in the present U.S. income tax treatment of deposits of nonresident aliens in U.S. banks and in their branches abroad. These deposit provisions would have a serious adverse effect on the ability of American banks to attract and maintain deposits from foreign sources and would result in a large outflow of funds from the United States. I am sure you will agree that this would not be in furtherance of our national objective to improve the U.S. balance-of-payments position, which is the primary aim of the proposed legislation.

Those sections of the new bill imposing a withholding tax on the interest earned by foreigners on deposits in U.S. banks would inevitably cause a large outflow of funds from the United States. Our experience shows that foreigners are very much aware of U.S. taxes and deposits would simply be transferred to Canadian, European, and other foreign banks in order to avoid the withholding tax. Thus, no additional tax revenue would be provided by the legislation. In fact, the proposal would probably result in a revenue loss to the Government since U.S. banks would have less available deposit funds from foreign sources and therefore would generate less profit subject to U.S. tax. Although the provisions would not take effect until 1971, there would without doubt be an earlier withdrawal of deposits.

One provision of the bill exempts foreign currency deposits in branches abroad but subjects U.S. dollar deposits to the tax. This provision would result in the complete disappearance from U.S. branches of dollar deposits and a large outflow of dollars from the United States to Europe. Dollar deposits maintained by non-U.S. residents in U.S. branches abroad represent extremely large sums, reaching into the hundreds of millions of dollars. In the case of our bank, more than half of the dollar deposits maintained in our London branches in the year 1965 were held by the branches in an interbranch account with our head office. No doubt, a similar situation exists in other U.S. banks. The balance of the dollar deposits of our branches, those not transferred to the United States, are used for financing in Europe or for activities of our branches in the United Kingdom. In the event the dollar deposits of our London branches were transferred to other banks, we would be forced to transfer substantial sums abroad to maintain our branch operations.

We recognize that the proposed legislation is not designed to apply a withholding tax to all deposits from abroad. Time deposits from foreign official institutions would continue to be exempted and demand deposits (which do not earn interest) would not seem to be affected. However, there is a strong interrelationship between the various types of foreign deposit accounts and our foreign financing activities. The disappearance of interest-bearing U.S. dollar deposits from private sources would substantially reduce the funds we lend abroad. As a consequence demand deposits related to foreign financing would be reduced, as would time deposits from official institutions which are frequently held with us as compensating balances in connection with foreign loans. About 95 percent of our dollar deposits in London comes from commercial banks; these would be directly subject to the withholding tax. About the same percentage of our foreign time deposits in the United States comes from official institutions; while these would continue to be exempted, the indirect result would be a reduction in official time deposits.

It is surprising that a bill which was designed to improve the U.S. balance of payments should contain new withholding tax provisions which would make it unattractive for foreigners to maintain interest-bearing dollar deposits with U.S. banks and would thus inevitably have an adverse effect on our balance of payments. H.R. 11297 would remove the withholding tax exemption on deposits of nonresident aliens, which has been part of the law since 1921 and which we understand was designed to encourage foreigners to transact financing business through U.S. banks. I feel sure that you will agree that the bill should be modified to exclude its present provisions for applying a new withholding tax on the interest earned by foreigners on deposits with U.S. banks.

Sincerely,

DAVID M. KENNEDY.

COUDERT BROS.,
ATTORNEYS AND COUNSELORS AT LAW,
New York, N.Y., February 14, 1966.

Mr. WILBUR D. MILLS,
Chairman, Committee on Ways and Means,
House of Representatives,
Washington, D.C.

DEAR MR. MILLS: We have noted with interest the proposed changes to the Internal Revenue Code as set forth in H.R. 11297 (Foreign Investors Tax Act of 1965).

In view of the far-reaching changes proposed in this act, which include the introduction of certain new and undefined concepts, it is respectfully submitted that your committee schedule hearings before the act is approved and sent to the House of Representatives.

The dimension of the changes and unforeseen effects of the "effectively connected" concept are so great as to make hearings on the subject an absolute necessity. It is my understanding that the Committee on Foreign Tax Problems of the Tax Section of the American Bar Association is preparing comments on the act which are in the process of completion. I am sure that these comments as well as other public comments that can be considered at open hearings will be of great interest to your committee and, accordingly, hearings should be scheduled.

Respectfully yours,

E. A. DOMINIANNI, Esq.

DAVIS, POLK, WARDWELL, SUNDERLAND & KIENDL,
New York, N.Y., February 24, 1966.

Hon. WILBUR D. MILLS,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR SIR: This letter comments on two aspects of H.R. 11297 now before your committee. It is respectfully submitted that those provisions of the bill dealing with gain from the sale of collapsible corporation stock, original issue discount and interest paid by foreign branches of domestic banks should be reexamined in the light of the technical and policy questions which they raise.

I

Technical and Policy Problems Suggested by Proposal To Tax Gain From the Sale of Stock in Collapsible Corporations and Original Issue Discount on the Same Basis as Investment Income

There is no published explanation of the proposal to amend section 871(a)(1) to provide a new subparagraph (C) and amend section 881(a) to provide a new paragraph (3) taxing section 341 gains and section 1232 gains realized by nonresident aliens and foreign corporations as if they were investment income. The application of these provisions to the two classes of income require separate consideration, for the classes of income themselves present different problems. Presumably, both categories of income have been equated with those items of pseudo capital gain already taxed to nonresident alien individuals and foreign corporations as investment income would be. However, lumping these two classes of income with investment income produces technical problems which the bill does not resolve. Moreover, this treatment appears to overlook policy problems which are interlocked with the technical problems.

TECHNICAL PROBLEMS OF ENFORCEMENT

The bill would amend section 1441(b) to revise the definition of items subject to withholding, but would not require withholding out of section 341 or section 1232 gains which would be taxed by the amended sections 871 and 881. Therefore, as the bill stands, there seems little prospect that the law taxing these gains would be enforced effectively. At the same time, it must be conceded that to require withholding from section 1232 gains would be cumbersome and to require withholding from section 341 gains would not only be burdensome, but could result in serious and unjustified penalties on domestic taxpayers.

Withholding from section 1232 gains would be mechanically difficult in even the simplest case, since the section 1232 gains realized by various taxpayers who sell bonds of a single series on the same day will vary according to their holding periods. More important, section 1232 applies only when a creditor has, overall, realized a gain from a sale of a debt instrument or upon its retirement. Accordingly, a withholding agent would be unable to compute the section 1232 gain of a seller (or holder at maturity) even if he knew the creditor's holding period and the total original issue discount inherent in the debt instrument at its inception. The withholding agent would have to know the taxpayer's basis as well.

To apply the rules of section 1441(c)(5) to withholding on section 1232 gains would be an extremely harsh remedy, completely inconsistent with the basic purpose of the bill. A modified version of the rule of section 1441(c)(5) could be drawn to require that 30 percent of all the original issue discount inherent in a debt instrument (not 30 percent of the proceeds from its sale or retirement) be withheld unless the creditor provided the withholding agent with the data concerning his holding period and basis required to make the necessary computations.

Even a withholding tax based on the principle of section 1441(c)(5) could be avoided readily in most cases by foreign holder A selling a U.S. debt instrument originally issued at a discount to foreign holder B outside the United States. B would thereby be placed in a position in which he could present the instrument for payment or sell it in a U.S. market, with a full disclosure of all facts relevant to his ownership but avoid withholding almost completely because the section 1232 gain allocable to his ownership would be minute. There would seem to be no practical method of guarding against this. In particular, full withholding levied against the last foreign holder, leaving him to recoup against his assignors and his assignors' predecessors would often produce more tax than would be due from a series of domestic holders all taxable at 30 percent, since some of the remote holders may have been people who have realized overall losses from their investments and who would, therefore, never have been subject to section 1232 tax had they been residents.[1] Most important, the excessively harsh results of such a system to unwary foreigners who were ultimate holders of a discount instrument would certainly drive away foreign investments in U.S. securities.

The mechanical complexities involved in withholding from section 341 gains would be much greater when account is taken of the endless intricacies of section 341(d) and section 341(e). It seems clear that a withholding requirement would present problems of administration infinitely more complex than those which can be anticipated from withholding on those pseudo capital gains which are presently subject to section 1441.

Beyond the mechanical complexities it would produce, the application of a withholding rule to section 341 gains would, inevitably, involve disputes as to the basic applicability of the taxing section. Presumably, a withholding agent could avoid these by withholding 30 percent of the proceeds of a sale transaction as if section 1441(c)(5) were applicable even if it were not specifically made so. However, if a withholding requirement were introduced, it would be inevitable that some Americans who purchased stock from foreign sellers would realize only after the event, and to their sorrow, that they had bought stock in a collapsible corporation from a foreigner and had become personally liable for a withholding tax. When this occurred, it would almost certainly occur under circumstances in which the foreign seller would be unavailable and the American purchaser would find it impossible to marshal evidence to defend against the applicability of the tax and impossible to recoup withholding tax from the person to whom it was in truth chargeable. Although a rule applying withholding to section 1232 gains would certainly not produce as many disputes over the basic applicability of the law as a requirement to withhold from section 341 gains would, there are substantial areas in which there is doubt whether original issue discount is inherent in a debt instrument (for example, if a debt instrument is given in payment for property purchased).

For all the above reasons, it seems both impractical and inequitable to extend section 1441 to require Americans to withhold on section 341 or section 1232 gains taxable to foreigners under the proposed amendments to sections 871 and 881. Thus, while the proposed extensions of sections 871 and 881 cannot be enforced effectively in their present form, it also seems unlikely that they could be enforced practically through withholding. It seems fundamentally wrong to enact any statute taxing foreigners if it can be anticipated that the statute cannot be thoroughly and equitably enforced.

TECHNICAL AND POLICY PROBLEMS SUGGESTED BY THE SOURCE RULES

The application of the source rules of the code suggests technical problems involved in an attempt to tax gains in the sale of collapsible corporation stock and original issue discount as investment in-

[1] Were a withholding tax imposed on the lines suggested, some of the prior holders might be U.S. citizens or residents not subject to withholding who had long since paid the tax allocable to those portions of the original issue discount inherent in the instrument which were realized by them at the termination of their holding periods.

come. A consideration of these technical problems suggests fundamental policy questions about the proposed statutory amendments.

It seems clear that gain from the sale of a collapsible stock has its source at the place where the stock is sold. Accordingly, the proposed amendments to sections 871 and 881 could easily be avoided by a knowledgeable foreigner simply by selling his collapsible stock abroad. Thus, in so far as they apply to section 341 gains, the amendments would do little more than create a trap for the unwary.

It is interesting to note that section 341 is not drawn with reference to U.S. individual income tax on the shareholders of the collapsible corporation. (Compare section 341(b) (1) with section 532(a) drawn to achieve a fundamentally similar purpose.) Taking the statute literally, there seems no bar to regarding a foreign corporation as collapsible even though it has had no contact whatever with the United States until the day its sole shareholder brings the certificate representing its stock into this country to sell it to an American purchaser. If that conclusion is correct, the bill would tax a Frenchman who sold the stock of a French corporation operating in France to an American at a closing in the United States if the French corporation met the collapsible tests. As a bare minimum, the bill should be revised to make it clear that this cannot occur.

The basic statutory pattern of section 341 perhaps implies that gain from collapsible stock should be considered to have as its source the place which would have been the source of the collapsible corporation's gain had it realized its income at the corporate level. Such a highly specialized source rule would certainly require extensive amendments of sections 861 et seq. based on assumptions about where unrealized gain would have been realized had it been realized. It is difficult to imagine that even the most elaborate provisions would function well in their application to any collapsible corporation other than one which was almost solely a real estate corporation.

The bill treats section 341 gains and section 1232 gains as if they presented identical technical problems in the context of the bill. As noted above, they would produce somewhat different problems were an attempt made to enforce the tax by withholding. The technical differences between the classes of income becomes even clearer when source of income problems are considered.

It seems clear that original issue discount taxable under section 1232 has a hermaphroditic character for income tax purposes. It is not subject to withholding because it is neither interest nor fixed or determinable annual or periodical income. Nonetheless, its functional equivalence to interest has required that discount income arising from a debt instrument be treated as income from the same source as stated interest paid or accrued on the same debt instrument. See appendix A. Accordingly, it seems clear that the amendments to sections 871 and 881 would tax only those original issue discounts realized on the obligations of debtors whose stated interest payments would have a U.S. source. Ibid. Although the conclusion from the authorities seems clear, the proposed amendments to sections 871 and 881 should not be enacted unless an explicit source rule for original issue discounts is made a part of the bill.

GENERAL COMMENT

If the United States lack general jurisdiction over a person realizing income from U.S. sources, it simply cannot make a seamless web of the tax law applicable to him unless it adopts withholding rules so harsh and impractical that they will cripple ordinary business transactions and drive bona fide foreign investors away from the United States. Upon analysis, it seems that section 341 and section 1232 (particularly the former) cannot apply fairly and effectively to foreigners over whom we do not have personal jurisdiction. Under these circumstances, it seems preferable to admit the deficiency and devote administrative and legislative effort to other problems which are more pressing than the closing of theoretical gaps which these provisions of the code may present.

II

Policy Problem Suggested by Proposed Amendment of the Source Rule for Interest Paid by Foreign Branches of Domestic Banks

The events of the last 6 months have demonstrated that the existing source rule for commercial bank interest puts U.S. banks operating abroad through branches at a disadvantage in comparison with foreign banks and those U.S. banks which operate through foreign subsidiaries rather than branches. U.S. corporations attempting to comply with the President's balance-of-payments objectives have raised extensive funds by long-term borrowings in European capital markets on the bonds of their financing subsidiaries so that the financing of their offshore operating subsidiaries may be accomplished without a dollar drain. Pending their ultimate use, the proceeds of these so-called Eurodollar bonds have been placed on short-term interest-bearing deposit. The financing subsidiaries which are the issuers of Eurodollar bonds must, as a practical matter, limit their income to foreign source income.[2] Accordingly, Eurodollar bond proceeds have been placed with foreign banks or the foreign affiliates of U.S. banks, depriving the foreign branches of U.S. banks of substantial business which they could have attracted under other source rules.

The proposed new section 861(a)(1)(D) would amend the interest source rules so that interest paid on foreign currency deposits by a foreign branch of a U.S. bank would be foreign source income. However, this would not substantially ameliorate the practical disadvantage imposed upon foreign branches of U.S. banks by the present source rule, since the principal completitive area in which the existing rules create a disadvantage is one in which dollar deposits are involved. It is submitted that the last clause of the proposed section 861(a)(1)(D) should be deleted and it should provide that any interest paid by a foreign branch of a U.S. corporation will be regarded as foreign source income so long as the foreign branch itself is engaged in a commercial banking business and the interest paid is on an obligation incurred in the course of that business by that branch.

Very truly yours,

JOHN P. CARROLL, Jr., Esq.

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[2] These financing subsidiaries would be required to withhold U.S. tax on their interest payments if they did not realize more than 80 percent of their income from foreign sources. Sec. 861(a)(1). European investors have been willing to invest in their debt instruments only on the condition that these financing subsidiaries indemnify the investors for withholding from them. Accordingly, withholding liabilities would be borne not by the European investors but by the financing subsidiaries.

APPENDIX A

Source of Original Issue Discount Income

Under sections 861(a)(1)(B) and 862(a)(1) of the Internal Revenue Code, the source of "interest" received from a domestic corporation may be either domestic or foreign. Interest paid by a domestic corporation constitutes income from sources without the United States if the corporation which paid it derived less than 20 percent of its gross income from United States sources during the three year period ending with the taxable year in which the interest was paid, or the lesser period since it was incorporated. Otherwise, interest paid by a domestic corporation constitutes income from sources within the United States. The purpose of this memorandum is to demonstrate that the source of original issue discount income is determined in the same manner as "interest".

1. UNDER CASE LAW AND RULINGS ORIGINAL ISSUE DISCOUNT HAS BEEN EQUATED WITH INTEREST

Where a debt instrument provides for a fixed return upon the money loaned payable at regular intervals by the borrower, those payments are customarily referred to as "interest". Where some or all of the return is provided instead by a lesser amount of money being loaned than the principal amount payable at maturity, the difference between principal and the amount loaned constitutes "original issue discount".[1] Original issue discount thus performs the same function as stated interest by providing the lender a fixed return upon his loan.

The functional equivalence of interest and original issue discount for income tax purposes is inherent in the definitions of "interest" that have been employed for income tax purposes. For example, the Supreme Court has characterized "interest" as: "* * * the amount which one has contracted to pay for the use of borrowed money" and as: "* * * compensation for the use or forbearance of money." *Old Colony Railroad Company* v. *Commissioner*, 284 U.S. 552, 560 (1932); *Deputy* v. *du Pont*, 308 U.S. 488, 498 (1940).

Original issue discount clearly fulfills the function of "interest" as so defined.

Similarly, § 1.543-1(b)(2) of the Income Tax Regulations, describing personal holding company income, provides that:

"The term 'interest' means any amounts, includible in gross income, received for the use of money loaned".

See also Regulations § 1.856-2(c)(2)(ii), respecting real estate investment trusts, providing that "interest" includes "only the amount which constitutes lawful interest for the loan or forbearance of money."

Because original issue discount performs the same economic function as interest, it has consistently been held that absent a compelling reason (not present here) for differentiating between the two forms of income, earned original issue discount is governed by the same rules

[1] The term "original issue discount" as used in this memorandum is employed in the sense mentioned, except where the context indicates that the section 1232(b)(1) definition is intended. The principal difference in the two definitions is that section 1232(b)(1) excludes discount of less than ¼% a year.

as interest for income tax purposes. The precedents directly in point are reviewed under the following topic. Authorities equating original issue discount income with interest under other sections of the Code are then discussed. Finally, reference will be made to legislation which demonstrates a Congressional intent that earned original issue discount and interest be treated in the same manner.

A. Authorities as to the Source of Original Issue Discount Income Hold That the Source is the Same as for Interest

The question of the source of original issue discount income was considered by the Service in I.T. 2330, VI–1 C.B. 76. Under section 233 of the Revenue Act of 1926, as under section 882(b) of the Internal Revenue Code, foreign corporations were subject to tax only upon domestic source income. Section 217(a)(1) of the 1926 Act, like section 861(a)(1)(B) of the Code, provided that "interest" from domestic corporations deriving 20 percent or more of their gross income from United States sources constituted United States source income. The question posed was whether this latter section was determinative of the source of income received by a foreign corporation which had purchased, and held to maturity, bankers acceptances issued at a discount by United States corporations which derived at least 20 percent of their gross income from this country.

I.T. 2330 held that irrespective of where payment was made at maturity, the source of income was to be determined in the same manner as interest and that therefore the taxpayer had received United States source income subject to tax. In equating the source rules for original issue discount income and interest, it was stated that:

"* * * It is believed that the gain derived upon the receipt of the principal at maturity of an interest-bearing obligation which was purchased at a discount should be regarded as having the same source as interest; that is, that the source of income depends upon the status of the obligor. * * *" VI–1 C.B. at page 77.

Prior to I.T. 2330 the Service had concluded that for withholding tax purposes appreciation upon bankers acceptances did not constitute "interest" or other "fixed or determinable annual or periodical income" under the sections corresponding to sections 1441 and 1442 of the Code, requiring withholding upon such types of United States source income paid to nonresident aliens and foreign corporations not in business here. 0.1024, 2 C.B. 189; I.T. 1398, 1–2, C. B. 149. These rulings would appear to have been based largely upon the practical consideration that since the amount of original issue discount income cannot be determined unless the purchase price of the obligation is known, a contrary conclusion would have resulted in withholding agents often being unable to compute the tax to be withheld.

Under section 231(a) of the Revenue Act of 1936, United States source income of foreign corporations not in business in the United States was, for the first time, subject to tax only if it was of a type that was also subject to withholding, that is, "fixed or determinable annual or periodical gains, profits, and income." This limitation is now embodied in section 881(a) of the Code.[2] As a consequence, even though under I.T. 2330 the source of income from bankers acceptances

[2] A like limitation applies to United States source income of nonresident alien individuals not engaged in trade or business in this country. 1936 Revenue Act, § 211(a); Code § 871.

issued by United States corporations at a discount, is domestic, it no longer is taxable to foreign corporations not engaged in trade or business in this country.

It is clear, however, that the characterization of original issue discount income for this purpose does not carry over to the source rules. This conclusion, follows not only from I.T. 2330—which was promulgated after 0.1024 and I.T. 1398—but from the fact that I.T. 1398 had itself spelled out that the source rule was different than the withholding rule. I.T. 1398 held in part, that:

"* * * where an agent in this country of a foreign bank, a corporation not having an office or place of business in the United States, purchases in this country bank acceptances at a certain rate of discount, and sells such acceptances for a price greater than the price for which purchased, the amount of gain received as the result of the transaction represents income from sources within the United States but not such income as is subject to withholding. * * *" I–2 C.B. 149.

See also O.D. 890, 4 C.B. 114, holding that gain realized by a foreign corporation or nonresident alien not in business in the United States upon the retirement of bonds of a foreign government or foreign corportions, regardless of whether payable at maturity abroad or in the United States "is in neither case derived from sources within the United States and, therefore, is not taxable."

Only a single court decision has been found dealing with the source of earned original issue discount, *Helvering* v. *Stein*, 115 F. 2d 468 (4th Cir. 1940), aff'g 40 B.T.A. 848 (1939), nonacq. 1940–1 C.B. 8, and the decision also accords with the source rules followed in the above rulings. Taxpayers in *Stein* were members of a German banking firm which dealt in negotiable instruments issued by the firm's customers in Germany. A transaction began by the firm acquiring a draft drawn by a customer for an amount less than face; that is, the firm acquired the paper at a "discount". It then transmitted the draft to New York where a United States bank "accepted" it by agreeing to pay the face amount. Immediately after "acceptance" the taxpayers' firm sold the paper either to the accepting bank or to a third party for an amount greater than it had paid for the draft but still less than face.

The "discount" on the sale after acceptance reflected the accepting bank's credit, since it had become the principal obligor. The firm had secured this credit through agreeing to pay the bank a fee for accepting the draft and by agreeing to repurchase all drafts presented to the bank at face two days before maturity.

The Commissioner argued that the members of the banking firm realized income from United States sources under the source of income rules governing the purchase and sale of property, since the firm had "purchased" drafts outside the United States and resold them in the United States. The Board held that the income was not taxable because the acquisition was not a "purchase." 40 B.T.A. at pp. 853, 855. The Court of Appeals decision made this same mechanical point. 115 F. 2d at pp. 471, 472.

However, the Court of Appeals went further and pointed out that the essence of the entire transaction was that the taxpayers' firm had advanced funds to its customers in Germany at a rate exceeding the costs of the firm's financing those advances in the United States. Accordingly,

"* * * The profit of the taxpayers was realized by virtue of the fact that they lent the money in Germany to their local customers at a much higher rate of interest than the taxpayers were compelled to pay to the New York Bank." 115 F. 2d at page 472.

The Court of Appeals decision in *Stein* stands for the same proposition as I.T. 2330. That is, that since original discount income is the functional equivalent of interest, the source of earned original issue discount is whatever would have been the source of stated interest were such interest paid by the obligor.

B. Authorities in Other Areas Treat Original Issue Discount Income the Same as Interest

1. Gain attributable to original issue discount constitutes ordinary income and not capital gain

The alternative to treating earned original issue discount as interest is to view the income as gain from the sale or exchange of property. If so viewed, sections 861(a)(1) and 862(a)(1) of the Code, dealing with the source of interest income, would not apply and source would be determined under the source rules pertaining to the sale of personal property. See Code Section 861(a)(6) and Rgs. § 861–7(a).

In United States v. *Midland-Ross Corp.*, 381 U.S. 54 (1965) and *Dixon* v. *United States* 381 U.S. 68 (1965) the Supreme Court considered in a different context this same question of whether original issue discount income should be taxed as interest or as gain from the sale of property. Both cases involved taxpayers who had purchased non-interest-bearing promissory notes from the issuers at prices below the face amounts of the notes and had sold the notes at a profit in a year prior to enactment of the provisions of section 1232 of the 1954 Code taxing earned original issue discount as ordinary income. The taxpayers claimed capital gains treatment under section 117(a) of the Internal Revenue Code of 1939, corresponding to section 1222 of the 1954 Code, which provided in part, that gain from the "sale or exchange of a capital asset" held for more than six months constitutes long-term capital gain.

The Court denied capital gains treatment in both instances, resting its opinion primarily upon the functional identity of original issue discount income and interest. It reasoned:

"Earned original issue discount serves the same function as stated interest, concededly ordinary income and not a capital asset; it is simply 'compensation for the use or forbearance of money.' *Deputy* v. *Du Pont*, 308 U.S. 488, 498; *cf. Lubin* v. *Commissioner*, 335 F. 2d 209 (C.A. 2d Cir.) * * * The $6 earned on a one-year note for $106 issued for $100 is precisely like the $6 earned on a one-year loan of $100 at 6% stated interest. The application of general principles would indicate, therefore, that earned original issue discount, like stated interest, should be taxed under § 22(a) as ordinary income." [3] *United States* v. *Midland-Ross Corp.*, 381 U.S. at pp. 57–58.

[3] In view of the decisions in *Midland-Ross* and *Dixon*, it may be desirable for the Service to reconsider O.D. 534, 2 C.B. 103. O.D. 534 held that (1) the collection at maturity by foreign corporations and nonresident alien individuals of British Treasury bills purchased by them in the United States at a discount constitutes income from sources outside the United States, whether collected in a foreign country or from a British paying agent in the United States, whereas (2) profit upon sale of the same bills in the United States constitutes United States source income. It is believed that the latter holding can be reconciled with *Midland-Ross* and *Dixon* only insofar as the profit is assumed to arise from appreciation of the securities due to a change in market conditions and cannot be reconciled insofar as the profit is attributable to the approach of the maturity date of the bills.

This reasoning is equally applicable to the question of the source of original issue discount income and, it is submitted, requires that the source of such income, like interest, be determined by the status of the payer.

2. Earned original issue discount upon State and local obligations constitutes tax-free interest

Section 103(a) of the Code exempts "interest" on state and local obligations from income tax. Where a state or municipality issues its bonds at a discount, the question arises whether a taxpayer who has purchased the bonds may treat as exempt under section 103(a) that portion of his gain upon sale or redemption of the bond as is attributable to the period he held it.

The Service has long answered this question affirmatively. G.C.M. 10452, XI–1 C.B. 18; I.T. 2629, XI–1 C.B. 20; G.C.M. 21890, 1940–1 C.B. 85; Rev. Rul. 60–210, 1960–1 C.B. 38. As stated in Rev. Rul. 60–210, the ruling position of the Service has been that:

"* * * discount at which bonds and similar obligations were *issued* constitutes compensation (where noninterest-bearing), or additional compensation (where interest-bearing), which the obligor had contracted to pay for the use of the money loaned and, hence, was equivalent to interest for Federal income tax purposes. * * *" 1960–1 C.B. at page 39, emphasis in the original.

The approach of the Service, exemplified in the quoted passage from Rev. Rul. 60–210, coincides with the rationale of the *Midland-Ross* and *Dixon* decisions. As suggested under the preceding heading, the same considerations apply with equal force in determining the source of original issue discount income.

3. Where a corporation sells its bonds it may amortize original issue discount and deduct the amount amortized over the life of the bonds in the same manner as annual interest

Section 1.61–12(c)(3) of the Income Tax Regulations provides, in pertinent part, that:

"If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. * * *"

This Regulation is another example of the general rule that original issue discount is to be treated as interest for income tax purposes. As explained by the Supreme Court in a case allowing deduction of amortization of bond discount and of related commissions incurred in marketing the bonds:

"Both commissions and discount, as the Government concedes, are factors in arriving at the actual amount of interest paid for the use of capital procured by a bond issue. The difference between the capital realized by the issue and par value, which is to be paid at maturity, must be added to the aggregate coupon payments in order to arrive at the total interest paid. * * *" *Helvering* v. *Union Pacific Railroad Company*, 293 U.S. 282, 286 (1934).

4. Original issue discount income is treated as interest for personal holding company purposes

Under Section 543(a)(1) of the Code, "personal holding company income" includes "interest". As noted earlier in this memorandum, the Regulations under Section 543 provide that:

"The term 'interest' means any amounts, includible in gross income received for the use of money loaned. * * *". Regs. § 1.543-1(b)(2).

In *Mayflower Investment Company* v. *Commissioner*, 239 F. 2d 624 (5th Cir. 1956), affirming 24 T.C. 729 (1955), the Court held that the difference between an amount loaned by the taxpayer and the greater amount payable to it upon maturity of the note constituted "interest" for this purpose. As a consequence, the taxpayer was held to be a personal holding company and was subject to personal holding company tax.

In construing the word "interest" as extending to the income in question, the Court relied upon Section 29.503-2 of Regulations 111 under the 1939 Code, containing the language above quoted from the present Regulations § 1.543-1(b)(2), and upon the Supreme Court's definition in *Deputy* v. *du Pont*, 308 U.S. 488, 498 (1940), supra, that "interest" is "compensation for the use or forbearance of money".

C. Congress Has Manifested an Intent That Earned Original Issue Discount Should be Treated as Interest

Evidence that Congress considers gain from obligations issued at a discount to be governed by the source rules for interest is furnished by section 861(a)(1)(C) of the Code. Section 861(a)(1) provides that "interest" upon domestic obligations constitutes income from sources within the United States, with certain exceptions, of which the last is: "(C) income derived by a foreign central bank of issue from bankers' acceptances."

The assumption of Congress in enacting section 119(a)(1)(C) of the Rvenue Act of 1928, which was the statutory predecessor of the present rule, appears to have been that without special legislation, the acceptances of United States bankers would produce United States source income in all cases. H.R. Rep. No. 2, 70th Cong., 1st Sess. 21 (1927); S. Rep. No. 960, 70th Cong., 1st Sess. 29 (1928). At the time of that enactment foreign central banks could not rely upon the rulings holding that such income was not "fixed or determinable annual or periodical gains, profits and income" since, until the Revenue Act of 1936, the failure of United States source income to fit that description only relieved the withholding agent from the obligation to withhold and did not provide an exemption to the ultimate recipient. See I.T. 1398, I-2 C.B. 149, supra.

More recently Congress has demonstrated on various occasions that except where, as in section 861(a)(1)(C), it has provided otherwise, it considers that original issue discount income is to be treated the same as interest for income tax purposes. A prominent example of the congressional design that the two forms of income be equated is provided in section 1232 of the 1954 Code.

Subsections (a)(2) and (b) of Section 1232 were enacted in the Revenue Code of 1954 to provide rules governing the taxation of amounts received on the sale, exchange or retirement of post-1964 obligations issued at a discount. Section 117(f) of the 1939 Code had provided that amounts received upon retirement of bonds were to be considered as "received in exchange" for the bonds. With Section 117(f) as the starting point, it was logical to include the new provisions among those relating to capital gains and losses, and to state the general rule and the exceptions thereto in terms of gain from the sale or exchange of property. The Committee Reports indicate clearly that original issue discount was viewed as interest income; the phrase "gain from the sale or exchange of property which is not a capital asset" employed in section 1232(a)(2) to describe the treatment of income to which the new provisions applied was intended to assure that earned discount would be reported as ordinary income and not as capital gain. H. Rep. No. 1337, 83d Cong., 2d Sess. 83, A277 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 112 (1954).

For example, the Senate Finance Committee stated that:

"In these cases, that part of the amount received on a sale or exchange which may represent a partial recovery of discount on original issue *is a form of interest income and in fact is deductible as an interest payment by the issuing corporation.*" S. Rep. No. 1622 at page 112, emphasis supplied; see also H. Rept. No. 1337 at page 83, embodying the italicized language.

Section 1232(a)(2)(B)(i), which excepts discount upon tax exempt obligations from the ordinary income treatment provided by Section 1232, further demonstrates that Congress viewed original issue discount as a form of interest.

Section 483 of the Code also illustrates that Congress views original issue discount and interest income as virtually identical for tax purposes. This section, enacted in 1964, requires, under certain circumstances, that the difference between the present value of an obligation and the face amount thereof (an amount analogous to original issue discount) be reported as interest income when installment paper received in exchange for property bears an unrealistically low interest rate, or no interest at all. H. Rep. No. 749, 88th Cong. 1st Sess. 73, A84 (1963); S. Rep. No. 830, 88th Cong. 2d. Sess. 101–102 (1964).

Section 483 classifies the imputed discount factor as interest, whereas Section 1232 prescribes that original issue discount is to be taxed as "gain from the sale or exchange of property which is not a capital asset". The difference in terminology is due to the difference between the factors which led to enactment of the respective sections, and not to a distinction in the nature of the income. The confused history of Section 117(f) of the 1939 Code, which had been enacted to ensure that retirement of a bond would be treated as a sale or exchange, but which had been interpreted by some courts to mean that original issue discount was a capital asset, prompted Congress to enact subsections 1232(a)(2) and (b) in 1954. Litigation in which the Internal Revenue Service sought unsuccessfully to impute interest when a contract did not call for it led to the enactment of Section 483. See *Kingsford Company*, 41 T.C. 646, 659 (1964), and cases cited therein. Although Section 483 was intended to halt "manipulation of the capital gains provisions,"[4] it was more appropriate to couch the section in terms of interest than in the language of the capital gains and loss sections because it—

(1) Applied to buyers as well as sellers,

(2) Included transactions resulting in a loss as well as those producing gain, and

(3) Included detailed standards for the determination of unstated interest.

[4] Statement by Secretary of Treasury, submitted to House Ways and Means Committee on February 6, 1963, CCH Report 12, vol. 50, pp. 89–90; Part I, Hearings, February 6, 7, and 8, 1963, at pp. 152–156.

Another recently enacted Code section also has an important bearing upon the proper characterization of original issue discount. Section 904(f) was added to the Code by section 10 of the Revenue Act of 1962 to prevent taxpayers whose foreign tax credits exceeded the allowable limitation under section 904 (prior to its amendment) from increasing the creditable amount by investing in foreign debt obligations. S. Report No. 1881, 87th Cong. 2d Sess., 1962–3 C.B. 707, 778 (1962). An underlying purpose of the section was to remove "an artificial inducement to the movement of U.S. capital abroad". 1962–3 C.B. at page 778.

Section 904(f) requires that in determining the limitation on credit a taxpayer compute separately, and without respect to the overall limitation, the amount of limitation on "interest income", as described in section 904(f)(2), and on all other income. "Interest" is not defined in the statute or committee reports, nor have proposed regulations under section 904(f) been promulgated.

Section 904(f) could be easily flouted if the Service were to conclude that the source of original issue discount were to be determined under rules respecting gain from the sale of property rather than the rules respecting interest. A taxpayer with excess foreign tax credits would then be free to increase its allowable foreign tax credit by purchasing indebtednesses issued by foreign corporations at a discount and either holding the obligations to maturity or selling them abroad before maturity. Assuming the gain was not taxed, or was only lightly taxed, by the foreign country, taxpayers in this manner would be able to increase their foreign tax credits allowable under section 904 notwithstanding enactment of section 904(f).[5]

For the reasons stated above, it seems clear that the source of original issue discount income in any case is the same as the source of stated interest paid by the obligor on the discount instrument under the rules of section 861(a)(1)(B) and 862(a)(1) of the Internal Revenue Code.

DAWSON, GRIFFIN, PICKENS & RIDDELL,
Washington, D.C., February 11, 1966.

MEMORANDUM

To: Hon. WILBUR D. MILLS, *Chairman,*
Committee on Ways and Means, U.S. House of Representatives.
From: JAMES W. RIDDELL.
Re Europe—Dollar companies and section 904(f).

Many U.S. corporations are confronted with the necessity for foreign expansion and have been unable to do so because of the balance-of-payments problem. Several U.S. taxpayers have obtained the

[5] If earned original issue discount were not treated as interest for source of income purposes, taxpayers might also be able to increase their section 904 limitation by purchasing obligations of domestic obligors at a discount and selling the obligations abroad before maturity. Whether they would be successful would depend upon whether the courst chose to follow such decisions as *Commissioner* v. *Phillips,* 275 F. 2d 33 (4th Cir. 1960, rev'g, 30 T.C. 866 (1958), and *Arnfeld* v. *Commissioner,* 163 F. Supp. 865 (Court of Claims 1958), *cert. den.* 359 U.S. 943, holding that sales of endowment policies shortly before maturity produced ordinary income, or followed the line of cases typified by *Barber-Green Americas, Inc.,* 35 T.C. 365 (1960), acq. 1961–2 C.B. 4, 1964–2 C.B. 4, which refused to apply a "tax avoidance" exception to the rule that sales income is realized in the country where title to the property sold passes. See Regs. § 1.861–7(a). It would seem likely that where the discount obligations were sold abroad well before their maturity date. the latter cases would control and the gain would constitute foreign source income.

required funds by borrowing U.S. dollars in foreign countries. This type of financing is intended solely to assist in improving the balance-of-payments position of the United States in compliance with the voluntary cooperation program instituted by the President.

It should be noted that this procedure is considerably more expensive than direct borrowing in the United States. This allegedly high money cost is the basis of a derivative action instituted by a stockholder of Standard Oil of Indiana (see Wall Street Journal, Feb. 8, 1966).

The preponderance of the companies obtaining funds in this manner have formed a new domestic corporation to issue the bonds and loan the proceeds to foreign affiliates. It is, of course, possible that withholding taxes will be imposed by various foreign countries with respect to interest paid to the financing subsidiary by the debtor foreign affiliates. The ultimate cost of these taxes to the domestic parent and the affiliated group will depend largely upon the extent to which they may be claimed as foreign tax credit under IRC sections 901 et seq.

It is possible that there may be a loss of foreign tax credit in respect to amounts withheld on interest payments (as described above) by reason of the additional limitations imposed by section 904(f). This provision limits the foreign tax credit otherwise available in the case of certain interest income. It requires the segregation of such interest from all other foreign income in applying the general code limitations on the use of foreign tax credits and restricts the taxpayer to the use of the "per country limitation" in respect thereof.

The following is an illustration of the loss of foreign tax credit which may result under section 904(f).

Interest received by domestic finance company from foreign affiliate (say, 6 percent of 5,000,000)	$300,000
Amount withheld at source (say, 30 percent of $300,000)	90,000
Expense attributable to interest income under "per country limitation" (say, 4½ percent of $5,000,000)	225,000
Net income derived from foreign country	75,000
Limitation for purposes of U.S. tax (48 percent of $75,000)	36,000
Unused foreign tax credit	54,000

Thus, in the above example, the amount withheld at source is imposed on gross income, while the per conutry limitation is based upon net income.

Section 904(f) does not apply to interest received from a corporation in which the taxpayer owns directly at least 10 percent of the voting stock. Therefore, it is conceivable that the impact of section 904(f) could be avoided simply by contributing to the capital of the domestic finance company 10 percent of the capital stock of all foreign subsidiaries from which interest income would be received. This, however, is a most undesirable alternative inasmuch as it produces a complicated and unwieldy corporate structure.

It should be noted also that the contribution route may not be available in the case of second-tier foreign subsidiaries. Furthermore, section 367 poses a problem in such a corporate reorganization.

Rather than go to the extreme of altering the corporate structure by means of capital contributions, as described above, the same result could be obtained if section 904(f)(1)(C) could be amended to read as follows:

"(C) Received from a corporation in which the taxpayer owns *or, if the taxpayer is a member of an affiliated group (as defined in section 1504(a), except that section 1504(b)(3) shall not apply) if another member of the affiliated group* owns at least 10 percent of the voting stock * * *" [Italic denotes additional language to be inserted in the statute.]

In essence, it appears to me that borrowing U.S. dollars in foreign markets is occasioned solely by the desire to comply with the President's voluntary program. It appears to be highly inequitable that a substantial detriment such as loss of foreign tax credit should be a direct consequence of such compliance. Moreover, the creation of a completely unwieldy corporate structure should not be necessitated in order to avoid such loss of foreign tax credit.

I shall be pleased to furnish any additional information you may require.

JAMES W. RIDDELL.

FIRST NATIONAL CITY BANK,
New York, N.Y., December 27, 1965.

Hon. WILBUR MILLS,
Chairman, House Ways and Means Committee,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: In late 1963, I served on a Presidential Task Force chaired by Henry Fowler, then Under Secretary of the Treasury, to examine ways and means of promoting increased foreign investment in the securities of U.S. private companies and increased foreign financing for U.S. business operating abroad. One of the areas where we made several recommendations was in the field of taxation. These recommendations for changes in taxation of foreign investors were intended to remove elements in our tax structure which complicate investment in this country without generating material tax revenues. Our proposals were conceived to simplify the tax laws and reporting requirements applicable to foreign investors; in part, to reduce taxation of foreign investors and also to make evident to the world that we welcome foreign investment. A review of the tax laws involving foreign investment in this country was high on our list of priorities for encouraging foreigners to make investments in our country.

The latest result of our efforts in this field is the present Foreign Investors Tax Act of 1965 (H.R. 11297), which is now pending with the House Ways and Means Committee. The current version of this bill proposes changes which, in my opinion, are regressive and not in harmony with our recommendations, to wit: (1) to increase estate tax rates for nonresident alien decedents over the rates originally recommended, and (2) the introduction of income and estate taxation on interest earned by foreigners on their deposits in U.S. banks. We are particularly concerned with the portion of the bill which proposes a withholding tax after December 31, 1970, on interest income from deposits of nonresident foreigners with our bank or branches of our bank in the United States or abroad. We have received a number of letters from our foreign branches overseas which point out very strongly that should such a law be enacted, our foreign branches would suffer considerable loss of dollar and foreign currency deposits as nonresident foreigners holding these deposits would merely walk across the street and put their money with Canadian, British, or European banks not doing business here and thereby avoid the tax. Deposits of such foreigners with our head office and domestic branches would likewise be shifted to foreign banks not subject to U.S. jurisdiction. This would have a drastic effect on our balance of payments and, certainly, this was not the intention of our committee. It is also evident that there would be no gain in revenue but probably a loss of tax payable by U.S. banks on the income they would generate on such deposits if the present interest-bearing deposits seek areas outside of the United States, where such tax would not apply.

We do not see any benefit from the proposed changes in this bill, while on the other hand the undesirable effects are substantial. We are, naturally, very much concerned with the adverse effects this bill in its present form would have on our deposit base both here and abroad, but just as important is the drastic effect it would have on our balance-of-payments position should it be enacted.

Sincerely,

WALTER B. WRISTON,
Executive Vice President.

HOUSE OF REPRESENTATIVES,
Washington, D.C., January 13, 1966.

Hon. WILBUR D. MILLS,
Chairman of Ways and Means,
House of Representatives,
Washington, D.C.

DEAR MR. CHAIRMAN: This letter concerns H.R. 5916 and H.R. 11297 in the Foreign Investors Tax Act.

It is my understanding that H.R. 11297 supersedes entirely H.R. 5916 on which hearings have already been held. It is also my understanding that additional public hearings have not been scheduled for H.R. 11297. This bill would have a serious impact on the economy of my district and all of south Texas because of our many ties with Mexico and other Latin American areas. It seems to me that a number of recent changes in the law have already hurt commerce and trade with Mexico, and it is my strong conviction that if this trend is not reversed, irreparable damage can result.

I would hope that any public hearings will be held on the new bill H.R. 11297, so that persons interested, including myself, would have a chance to express themselves on the contemplated changes in the tax laws with respect to foreign investment in the United States. As you know, the banking industry has already made a significant contribution on a voluntary basis in our balance-of-trade problem.

Sincerely yours,

HENRY B. GONZALEZ,
Member of Congress.

NORTH MASSAPEQUA, LONG ISLAND, N.Y.,
February 21, 1966.

Hon. WILBUR D. MILLS,
House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN MILLS: Your committee now has H.R. 11297 under consideration. Originally a tax bill was recommended by the Fowler committee to reform U.S. taxation in order to stimulate foreign investment in the United States. In its present form, H.R. 11297 would reduce U.S. exports by taxing foreign purchasing entities in the United States, make it more difficult for U.S. firms to earn income on their direct foreign investments, tend to reduce foreign investment in the United States, and in general, worsen the U.S. balance-of-payments problem.

H.R. 11297 introduces a radical concept of nexus in attributing and taxing the global income of a foreign corporation "effectively connected with" the conduct of a trade or business in the United States. The traditional source-of-income rules would give way to nebulous and vague guidelines such as whether the business activities in the U.S. are a "material factor" in generating any income of the foreign corporation. Thus, a stigma would be placed on foreign subsidiaries owned by a U.S. corporation which has an international division to provide certain managerial services. Under current law, and current practice, the U.S. corporation would charge its subsidiaries for this service or face a reallocation under section 482 of the Internal Revenue Code. This new bill would in fact attempt to attribute "income" of the foreign subsidiary to the United States, which subsidiary in fact conducts no real business in the United States, merely due to the general "overseeing function" of the U.S. parent who is interested in its foreign investment. These same nebulous guidelines could also encompass income of a foreign corporation who purchases in the United States for resale abroad. Under current rules the sales destination is the primary source of income. It is difficult to understand how the United States could tax a foreign corporation which merely purchases goods in this country and it is even more difficult to understand how such a bill would help our balance of payments by discouraging foreign purchasers.

It is our opinion that this new doctrine will contravene the traditional rules of "permanent establishment" in U.S. double-tax treaties and impose almost insurmountable problems in international tax planning.

If the stated purpose of the bill, "to modernize the present U.S. tax treatment of foreigners and to encourage foreign investment in the United States" is to be accomplished, its application should be limited to corporations which are majority owned by foreigners.

We respectfully urge that hearings on this bill be held by the House Ways and Means Committee so that the business community can comment on the inequity of its provisions.

Thank you for your consideration.

CHARLES GREENBERG.

HUBACHEK, KELLY, MILLER, RAUCH & KIRBY,
ATTORNEYS AT LAW,
Chicago, Ill., December 3, 1965.

Re Section 8 of H.R. 11297.

Hon. WILBUR D. MILLS,
Chairman, Ways and Means Committee,
House of Representatives,
Washington, D.C.

DEAR MR. MILLS: It is clear that the estate tax proposals in section 8 of H.R. 11297 would not improve our balance-of-payments deficit or defend our gold reserves. On the contrary, enactment of these proposals would have the opposite effect.

The key recommendation of the President's task force was complete elimination of U.S. estate taxes on all intangible personal property of nonresident alien decedents. The task force pointed out that the annual estate tax revenue loss would be negligible. H.R. 11297 effectively rejects this task force recommendation.

In the first place, the task force recognized that the United States could not expect to attract substantial foreign investment in securities so long as our estate tax rates are appreciably higher than those imposed by other countries. Even the 5- 10- 15-percent rate schedule proposed in H.R. 5916 would be higher than the corresponding rate schedules of Switzerland, France, Germany, and the Netherlands—the most prosperous countries in continental Europe. It is inconceivable, therefore, that citizens of those countries would be encouraged to invest here by reason of the even higher 5- to 25-percent rate proposed by H.R. 11297.

In the second place, section 8 of H.R. 11297 proposes to greatly enlarge the traditional estate tax base applicable to nonresident alien decedents. This would be extremely unwise and would go flatly contrary to the stated objectives of the bill. Requiring the inclusion of corporate bonds and bank deposits in the estate tax base will not only fail to attract foreign invesment but will drive existing foreign investment away. Enormous foreign cash and bond balances have built up here under existing law. If sections 8(c) and 8(d) are enacted, these balances will be withdrawn by the simple expedients of writing a check or tax-free sales.

In the third place, the task force recommendations to the private sector of our economy have been adopted to a most encouraging degree. Enactment of section 8 of H.R. 11297 would represent a total failure by the Government to support the U.S. financial community in its renewed effort to attract foreign investment.

Mr. Mills, I urge your committee to reject section 8 of H.R. 11297 and to adopt instead the task force recommendation to eliminate the estate tax on intangible personal property. The job of reducing our balance-of-payments deficit and reversing our gold drain must be accomplished. It deserves positive and direct action by the Congress. Section 8 of H.R. 11297 obviously is not the answer.

Sincerely yours,

GEORGE W. RAUCH.

HUBACHEK, KELLY, MILLER, RAUCH & KIRBY,
ATTORNEYS AT LAW,
Chicago, Ill., February 14, 1966.

Re Section 8 of H.R. 11297.

Hon. WILBUR D. MILLS,
Chairman, Committee on Ways and Means,
House of Representatives,
Washington, D.C.

DEAR CONGRESSMAN MILLS: The stated purposes of H.R. 11297 are to modernize the present U.S. tax treatment of foreigners and to encourage foreign investment in the United States. Section 8 of that bill, which revises the U.S. estate taxation of nonresident alien decedents, obviously fails to achieve these purposes. In fact, enactment of this section 8 would have a decidedly adverse effect on our balance-of-payments position.

The President's task force flatly stated that the present U.S. estate tax situation constitutes one of the major deterrents to foreign investment in this country and recommended complete elimination of the tax on intangible personalty owned by nonresident alien decedents. Section 8 of H.R. 11297 proposes new estate tax rates on nonresident alien decedents ranging up to 25 percent and at the same time broadens the present estate tax base by requiring the inclusion of U.S. corporate bonds (located outside the United States) and bank deposits, which are exempted under present law. This proposal is absurd. It completely ignores the task force recommendation and reality. Foreigners will not be encouraged to invest more money here. Far from it. They will simply liquidate their present U.S. bond investments and bank accounts and take the proceeds abroad to escape the U.S. tax. The result would be an immediate gold drain in the hundreds of millions of dollars. Furthermore, section 8 could have a disastrous effect on the present efforts of U.S. corporations to obtain foreign financing. For example, in 1965, U.S. corporations placed abroad a total of $339 million in Eurodollar bonds and are already placing an additional $190 million so far this year. By subjecting these bonds to possible U.S. estate tax, section 8 could seriously impair their market and force U.S. corporations to finance their foreign operations with U.S. dollars.

If the Congress really means business about wanting to improve our disastrous balance-of-payments situation, the task force estate tax proposal should be adopted. As a possibly acceptable alternative, estate tax rates no higher than the 5–10–15 percent scale which you proposed in H.R. 5916 should be adopted and the present estate tax exemption of bank accounts and bonds should be retained. I have attached a substitute version of section 8 of H.R. 11297 which reflects this outside alternative. I urge you to recommend to your committee that either the task force proposal or this substitute for section 8 be adopted.

Respectfully yours,

GEORGE W. RAUCH.

SEC. 8. ESTATES OF NONRESIDENTS NOT CITIZENS.

(a) RATE OF TAX.—Subsection (a) of section 2101 (relating to tax imposed in case of estates of nonresidents not citizens) is amended to read as follows:

"(a) RATE OF TAX.—Except as provided in section 2107, a tax computed in accordance with the following table is hereby imposed on the transfer of the taxable estate, determined as provided in section 2106, of every decedent nonresident not a citizen of the United States:

"If the taxable estate is:	The tax shall be:
Not over $100,000	5 percent of the taxable estate.
Over $100,000 but not over $750,000	$5,000, plus 10 percent of excess over $100,000.
Over $750,000	$70,000, plus 15 percent of excess over $750,000."

(b) CREDITS AGAINST TAX.—Section 2102 (relating to credits allowed against estate tax) is amended to read as follows:

"SEC. 2102. CREDITS AGAINST TAX.

"(a) IN GENERAL.—The tax imposed by section 2101 shall be credited with the amounts determined in accordance with sections 2011 to 2013, inclusive (relating to State death taxes, gift tax, and tax on prior transfers), subject to the special limitation provided in subsection (b).

"(b) SPECIAL LIMITATION.—The maximum credit allowed under section 2011 against the tax imposed by section 2101 for State death taxes paid shall be an amount which bears the same ratio to the credit computed as provided in section 2011(b) as the value of the property, as determied for purposes of this chapter, upon which State death taxes were paid and which is included in the gross estate under section 2103, bears to the value of the total gross estate under section 2103. For purposes of this subsection, the term 'State death taxes' means the taxes described in section 2011(a)."

(c) DEFINITION OF TAXABLE ESTATE.—Paragraph (3) of section 2106(a) (relating to deduction of exemption from gross estate) is amended to read as follows:

"(3) EXEMPTION.—

"(A) GENERAL RULE.—An exemption of $30,000.

"(B) RESIDENTS OF POSSESSIONS OF THE UNITED STATES.—In the case of a decedent who is considered to be a 'nonresident not a citizen of the United States' under the provisions of section 2209, the exemption shall be the greater of (i) $30,000, or (ii) that proportion of the exemption authorized by section 2052 which the value of that part of the decedent's gross estate which at the time of his death is situated in the United States bears to the value of his entire gross estate wherever situated."

(d) SPECIAL METHODS OF COMPUTING TAX.—Subchapter B of chapter 11 (relating to estates of nonresidents not citizens) is amended by adding at the end thereof the following new sections:

"SEC. 2107. EXPATRIATION TO AVOID TAX.

"(a) RATE OF TAX.—A tax computed in accordance with the table contained in section 2001 is hereby imposed on the transfer of the taxable estate, determined as provided in section 2106, of every decedent nonresident not a citizen of the United States dying after the date of enactment of this section, if after March 8, 1965, and within the 10-year period ending with the date of death such decedent lost United States citizenship, unless such loss did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle A.

"(b) GROSS ESTATE.—For purposes of the tax imposed by subsection (a), the value of the gross estate of every decedent to whom subsection (a) applies shall be determined as provided in section 2103, except that—

"(1) if such decedent owned (within the meaning of section 958(a)) at the time of his death 10 percent or more of the total combined voting power of all classes of stock entitled to vote of a foreign corporation, and

"(2) if such decedent owned (within the meaning of section 958(a)), or is considered to have owned (by applying the ownership rules of section 958(b)), at the time of his death, more than 50 percent of the total combined voting power of all classes of stock entitled to vote of such foreign corporation,

then that proportion of the fair market value of the stock of such foreign corporation owned (within the meaning of section 958(a)) by such decedent at the time of his death, which the fair market value of any assets owned by such foreign corporation and situated in the United States, at the time of his death, bears to the total fair market value of all assets owned by such foreign corporation at the time of his death, shall be included in the gross estate of such decedent. For purposes of the preceding sentence, a decedent shall be treated as owning stock of a foreign corporation at the time of his death if, at the time of a transfer, by trust or otherwise, within the meaning of sections 2035 to 2038, inclusive, he owned such stock.

"(c) CREDITS.—The tax imposed by subsection (a) shall be credited with the amounts determined in accordance with sections 2011 to 2013, inclusive (relating to State death taxes, gift tax, and tax on prior transfers), as modified by section 2102(b).

"(d) EXCEPTION FOR LOSS OF CITIZENSHIP FOR CERTAIN CAUSES.—Subsection (a) shall not apply to the transfer of the estate of a decedent whose loss of United States citizenship resulted from the application of section 301(b), 350, or 355 of the Immigration and Nationality Act, as amended (8 U.S.C. 1401(b), 1482, or 1487).

"(e) BURDEN OF PROOF.—If the Secretary or his delegate establishes that it is reasonable to believe that an individual's loss of United States citizenship would, but for this section, result in a substantial reduction in the estate, inheritance, legacy, and succession taxes in respect of the transfer of his estate, the burden of proving that such loss of citizenship did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle A shall be on the executor of such individual's estate.

"SEC. 2108. APPLICATION OF PRE-1966 ESTATE TAX PROVISIONS.

"(a) IMPOSITION OF MORE BURDENSOME TAX BY FOREIGN COUNTRY.—Whenever the President finds that—

"(1) under the laws of any foreign country, considering the tax system of such foreign country, a more burdensome tax is imposed by such foreign country on the transfer of estates of decedents who were citizens of the United States and not residents of such foreign country than the tax imposed by this subchapter on the transfer of estates of decedents who were residents of such foreign country,

"(2) such foreign country, when requested by the United States to do so, has not acted to revise or reduce such tax so that it is no more burdensome than the tax imposed by this subchapter on the transfer of estates of decedents who were residents of such foreign country, and

"(3) it is in the public interest to apply pre-1966 tax provisions in accordance with this section to the transfer of estates of decedents who were residents of such foreign country,

the President shall proclaim that the tax on the transfer of the estate of every decedent who was a resident of such foreign country at the time of his death shall, in the case of decedents dying after the date of such proclamation, be determined under this subchapter without regard to amendments made to sections 2101 (relating to tax imposed), 2102 (relating to credits against tax), and 6018 (relating to estate tax returns) on or after the date of enactment of this section.

"(b) ALLEVIATION OF MORE BURDENSOME TAX.—Whenever the President finds that the laws of any foreign country with respect to which the President had made a proclamation under subsection (a) have been modified so that the tax on the transfer of estates of decedents who were citizens of the United States and not residents of such foreign country is no longer more burdensome than the tax imposed by this subchapter on the transfer of estates of decedents who were residents of such foreign country, he shall proclaim that the tax on the transfer of the estate of every decedent who was a resident of such foreign country at the time of his death shall, in the case of decedents dying after the date of such proclamation, be determined under this subchapter without regard to subsection (a).

"(c) NOTIFICATION OF CONGRESS REQUIRED.—No proclamation shall be issued by the President pursuant to this section unless, at least 30 days prior to such proclamation, he has notified the Senate and the House of Representatives of his intention to issue such proclamation.

"(d) IMPLEMENTATION BY REGULATIONS.—The Secretary or his delegate shall prescribe such regulations as may be necessary or appropriate to implement this section."

(e) ESTATE TAX RETURNS.—Paragraph (2) of section 6018(a) (relating to estates of nonresidents not citizens) is amended by striking out "$2,000" and inserting in lieu thereof "$30,000".

(f) CLERICAL AMENDMENT.—The table of sections for subchapter B of chapter 11 (relating to estates of nonresidents not citizens) is amended by adding at the end thereof the following:

"Sec. 2107. Expatriation to avoid tax.
"Sec. 2108. Application of pre-1966 estate tax provisions."

(g) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to estates of decedents dying after the date of the enactment of this Act.

INSTITUTE ON U.S. TAXATION OF FOREIGN INCOME, INC.,
New York, N.Y., February 18, 1966.

Re H.R. 11297.

Hon. LEO H. IRWIN,
Chief Counsel, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. IRWIN: The position of this institute can be very briefly stated with respect to H.R. 11297. We have no opposition to its prompt passage, provided that it is limited to its announced purpose, to comply with the express wish of President Johnson:

> " * * * to modernize the present U.S. tax treatment of foreigners and to encourage foreign investment in the United States—thereby beneficially affecting the U.S. balance-of-payments—by removing tax barriers to such investment."

In order to avoid harmful effects which otherwise would result to U.S. corporations engaged in foreign trade and to the U.S. balance-of-payments, it is essential that the "effectively connected" provisions of H.R. 11297 (e.g., proposed amended Internal Revenue Code sec. 882) be limited so as to be applicable only to foreign corporations controlled by foreigners (i.e., by persons other than U.S. persons).

If the title and statement of the purpose of H.R. 11297 fairly state its purpose, there is no reason why its application should not be limited to foreign investors and foreign investments in the United States.

That is all we ask—and we earnestly request the opportunity to bring out the facts in open hearings on these new provisions of H.R. 11297.

We recognize that it would be impossible to correct what are believed to be technical flaws in H.R. 11297 and still effect its prompt passage as desired by the administration. However, we feel that it is worth while to point out a few of these flaws:

1. H.R. 11297 would do away with the exemption otherwise allowable under the Export Trade Corporation provisions of Internal Revenue Code section 970 (proposed new sec. 952(b)).
2. The proposed new section 906(a) apparently would allow a foreign subsidiary corporation credit for foreign taxes paid and deemed paid by it with respect to U.S. income subject to tax under the "effectively connected" provisions and *also* would allow its U.S. parent credit for the same foreign income taxes *deemed* paid by it (the U.S. corporation) with respect to dividends received from such foreign subsidiary.
3. There is no indication that, if the worldwide income of a foreign subsidiary were connected with its U.S. activities, the amount subject to tax under the proposed section 882 would be limited to the portion properly allocable to such U.S. activities.
4. Apparently, no consideration has been given to the effect of the "effectively connected" provisions (e.g., proposed sec. 882

and sec. 952(b)) upon the "minimum distribution" provisions of section 963.

Time and space do not permit further enumeration of technical flaws in this bill.

The substantive objection is that in attempting to afford U.S. tax incentives to foreign investors, it would impose various unjustifiable penalties on foreign corporations owned and controled by U.S. persons.

You are respectfully requested to distribute copies of this statement to members of the Ways and Means Committee and to include this statement in the committee print.

Thanking you in advance for your attention to this request, I remain,

Sincerely yours,

PAUL D. SEGHERS, *President.*

INSTITUTE ON U.S. TAXATION OF FOREIGN INCOME, INC.,
New York, N.Y., February 19, 1966.

Re H.R. 11297.

Hon. LEO H. IRWIN,
Chief Counsel, Committee on Ways and Means, House of Representatives, Washington, D.C.

DEAR MR. IRWIN: Please add to our letter dated yesterday (February 18) our suggestion for wording to accomplish the recommended changes in the provisions of H.R. 11297 so as not to penalize foreign corporations owned by U.S. persons.

In lieu of the amendment of IRC section 882(b) proposed in section 4(b) of H.R. 11297, we suggest the following:

"(b) GROSS INCOME.—

"(1) FOREIGN OWNED CORPORATIONS.—In the case of a foreign corporation controlled (through the ownership, direct or indirect, of more than 50 percent of its voting stock) by persons who are not U.S. persons (as defined in sec. 957) gross income includes only—

"(A) 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 within the United States, and

"(B) gross income which is effectively connected with the conduct of a trade or business within the United States, to the extent attributable to such activities.

"(2) OTHER FOREIGN CORPORATIONS.—In the case of all other foreign corporations, gross income includes only gross income from sources within the United States."

This wording would:

(1) Limit the application of the proposed new "effectively connected" provisions to those persons whom H.R. 11297 is intended to benefit, foreign investors, without adding new burdens of U.S. taxes on U.S. manufacturers and other U.S. corporations having foreign subsidiaries engaged in foreign trade, and

(2) Limit the impact of the proposed "effectively connected" provisions so as to tax foreign-owned and controlled foreign corporations

on only so much of their foreign income as is attributable to their activities in the United States.

Both of these results would be more in harmony with the stated purposes of H.R. 11297 than would the consequences of the section 882(b) proposed in H.R. 11297 (as introduced).

The change we propose herein would eliminate the need for the amendment of IRC section 952(b), now proposed in H.R. 11297, and thus would avoid the nullification, in many instances, of the benefits intended to be afforded by section 970 to "Export Trade Corporations," and avoid many other complications under "subpart F."

In addition to the serious defects in H.R. 11297 enumerated in our February 18 letter, we point out that, under H.R. 11297 as introduced, "effectively connected" income would, in some cases, be taxed twice, at full U.S. corporation rates; first to the foreign corporation and then, when distributed as a dividend, to its U.S. parent corporation, without allowing any credit or other relief from this unbearable burden.

To continue to point out defects in H.R. 11297 when applied to U.S.-owned and controlled corporations would only distract attention from the one essential issue—the vital need to exclude such U.S.-owned corporations from the application of these novel "effectively connected" provisions.

We will greatly appreciate your cooperation in transmitting our suggestions to the chairman and members of the Committee on Ways and Means and including in the committee print our two letters submitting these suggestions.

Very truly yours,

PAUL D. SEGHERS,
President.

INTERNATIONAL ECONOMIC POLICY ASSOCIATION,
Washington, D.C., February 9, 1966.

Hon. WILBUR D. MILLS,
Chairman, House Ways and Means Committee,
Washington, D.C.

DEAR CONGRESSMAN MILLS: The attention of the International Economic Policy Association, representing some of the major American industrial corporations with substantial investments abroad, has been called to the provisions of H.R. 11297, introduced by you last September.

While this bill generally incorporates the provisions of H.R. 5916, the so-called Fowler bill, designed to encourage foreign investment in the United States, H.R. 11297 goes far beyond the original Fowler bill in incorporating substantial changes in the basic rules for determining the income of foreign corporations doing business in the United States. Since original enactment in 1918, such corporations have been taxed *only* on their income from clearly defined U.S. sources. Under the proposed provisions of H.R. 11297, such corporations may be subject to U.S. income tax on income that is "effectively connected" with the United States even though such income is, admittedly, from non-U.S. sources.

It is not the purpose of this letter to question the advisability or inadvisability of such a fundamental change in U.S. tax law. However, the association is firmly convinced that a change having such a profound impact on historical U.S. tax principles is one that should require the most thorough consideration by your committee. We sincerely believe that the constitutional obligation imposed on the House of Representatives to propose revenue legislation requires full public exploration of all basic changes in U.S. tax provisions and we must, in honesty, state that we feel that it would be remiss for Congress to make such far-reaching changes without affording an opportunity for full public hearings.

We know that your committee is fully aware of the proposed legislation but we doubt whether all U.S. taxpayers affected by it are fully cognizant of the substantive changes proposed in this bill. Although comments on H.R. 5916 were requested, public hearings have never been held. Accordingly, we respectfully request that your committee hold public hearings on H.R. 11297. If such hearings are held, we wish to assure you that the IEPA will endeavor to present constructive views on the proposed legislation and on any modifications to this legislation that we feel are desirable.

Sincerely yours,

N. R. Danielian, *President.*

Statement by International Telephone & Telegraph on H.R. 11297

H.R. 11297, more commonly known as the Fowler bill, is a bill designed to encourage foreign investment in the United States. It has received a broad spectrum of public support for these objectives. However, as introduced by Chairman Mills last September the bill contains a significant change in basic U.S. tax policy, a change that has not had the benefit of full public discussion or understanding.

Since the earliest days of income taxation in this country, going back to the Revenue Acts of 1916 and 1918, a foreign corporation engaged in trade or business within the United States has been taxed only on its income from clearly defined sources within the United States. However section IV of H.R. 11297 changes this long-established pattern of taxation by amending section 882 of the Internal Revenue Code to subject a foreign corporation engaged in trade or business within the United States to taxation on its income which is "effectively connected" with the conduct of such trade or business.

Under this proposed fundamental change in U.S. tax law, the traditional source rules now contained in sections 861 through 864 of the code are no longer to determine the scope of U.S. taxation of foreign corporations engaged in trade or business in the United States. From a position of relative certainty permitting business judgment and action, foreign corporations which wish to engage in trade or business within the United States will have to act at their peril, with exposure to U.S. income tax being limited only by the vague general concept "effectively connected income."

No greater criticism of this vague concept can be found, it is submitted, then the inability of the draftsman of H.R. 11297 to define the term "effectively connected income." Section II of H.R. 11297 amending section 864 of the code relating to definitions under the source of income rules seeks to define the term "effectively connected income, etc.," but the proposed definition does not even purport to be a definition; it merely lists three factors which are to be "taken into account" in determining whether income is "effectively connected" with the conduct of a trade or business. These factors are:

> (1) Whether the income is derived from assets used in, or held for use in, the conduct of such trade or business; (2) whether income is accounted for through such trade or business; or (3) whether activities of trade or business were a material factor in the realization of the income.

These three factors are merely three additional elements of uncertainty added to the basic uncertainty of "effectively connected income."

Uncertainty added to uncertainty is a far cry from operating under the relatively certain source rules now contained in the code, rules which have been amplified by years of experience, Treasury regulations and rulings, and court decisions. The underlying purpose behind H.R. 11297 is to encourage foreign investment in the United States. The almost certain broadening of a foreign corporation's income subject to U.S. tax liability under H.R. 11297 will lead to no such encouragement. On the contrary, it will lead to foreign corporations withdrawing from the United States to the further impairment of our balance-of-payments position. This is not a purpose consistent with the committee studies that led to the introduction of H.R. 11297.

Taxpayers concerned about the impact of this almost hidden change incorporated in H.R. 11297 have received informal assurance from Treasury officials that the bill, if enacted, will be administered sympathetically but the function of the Internal Revenue Service is to protect the revenue of the United States and statements of intended "sympathetic administration" by Treasury officials today cannot and will not prevent the Internal Revenue Service from the most possible restrictive enforcement tomorrow. The "effectively connected income" approach sought by the Treasury Department will lead to taxation measured not by rule of law but by administrator's fiat. It is submitted that no such approach should be enacted.

The MANUFACTURERS LIFE INSURANCE CO.,
Toronto, Canada, January 19, 1966.

Re H.R. 11297, Foreign Investors Tax Act of 1965.

DR. LAURENCE N. WOODWORTH,
Chief of Staff,
Joint Committee on Internal Revenue Taxation,
Washington, D.C.

DEAR DR. WOODWORTH: Enclosed are three copies of the memorandum which it was arranged we should prepare following our meeting with you and your associates in Washington on December 16 last. The points discussed are features of the above bill which present special problems for Canadian life insurance companies doing business in the United States, and are an elaboration of the questions considered in regard to them at the meeting. The points in question relate to (*a*) income effectively connected and income not effectively connected, (*b*) settlement of proposed section 881 tax, and (*c*) adjustment of proposed section 881 tax for any overlapping due to the operation of the minimum surplus provision of section 819.

May I say again how much we appreciated the opportunity of meeting with you and your associates. The meeting was most helpful and we believe the memorandum will serve to recapitulate our comments.

This letter and memorandum are written on behalf of the 13 Canadian life insurance companies doing business in the United States.

Sincerely,

(S) E. C. ROBINSON,
Associate Secretary.

(Per favor of Mr. Kenneth L. Kimble, vice president and general counsel, Life Insurance Association of America, Washington, D.C.)

Memorandum to: Dr. Laurence N. Woodworth, Chief of Staff, Joint Committee on Internal Revenue Taxation.

H.R. 11297—FOREIGN INVESTORS TAX ACT OF 1965

This memorandum relates to our discussion with you and your associates, Messrs. Vic Willett and Carl Nordberg, in Washington on December 16, respecting features of the above bill affecting the income tax procedure of foreign life insurance companies doing business in the United States. For ready reference, we give below the names, apart from yourselves, of those who joined in the meeting:

Mr. Kenneth L. Kimble, vice president and general counsel, LIAA.

Mr. William B. Harman, Jr., associate general counsel, ALC.

Mr. A. E. Loadman, vice president and actuary, the Great-West Life.

Mr. H. E. Harland, associate actuary, the Great-West Life.

Mr. T. B. Morrison, actuarial vice president, the Manufacturers Life.

Mr. E. C. Robinson, associate secretary, the Manufacturers Life.

Mr. L. J. Brown, associate actuary, the Sun Life.

It was arranged that, in the memorandum, we should review our comments on the following three points—

(*a*) Income effectively connected and income not effectively connected.

(*b*) Settlement of proposed section 881 tax.

(*c*) Adjustment of proposed section 881 tax for any overlapping due to the operation of the minimum surplus provision of section 819.

(*a*) *Income "effectively connected" and "income not effectively connected"*

A foreign life insurance company which qualifies as a life insurance company under section 801 of the code, is, in accordance with the provisions of section 819(a), taxable on its U.S. business in the same manner as a domestic life insurance company.

H.R. 11297 would amend the code by deleting section 819(a) and in its place would provide a new tax procedure for such companies involving a new nomenclature for defining taxable income.

Under section 842 of the new bill, a qualifying foreign life insurance company would be taxed on "income effectively connected with the conduct of any trade or business within the United States" at regular corporate tax rates. In addition, under new section 881, income, as there defined, from sources within the United States not effectively connected would be taxed at the 30 percent statutory withholding rate or lower treaty rates. Under the new procedure, the taxable income of such companies is to be classified under one or other of the foregoing categories of income, and it therefore becomes essential that there should be clear guidelines for such classification of taxable income.

Evidently, new section 842 replaces existing section 819(a). Therefore, based on the intent indicated in paragraph 22 of the committee print, we conclude that the expression "income effectively connected, etc." in new section 842 has the same connotation as "United States business" in section 819(a) in relation to a qualifying foreign life insurance company doing business in the United States.

It has been recognized that the authoritative source of information respecting the U.S. business of a foreign life insurance company is the annual statement of its U.S. business which such company is required to prepare on the form prescribed by the National Association of Insurance Commissioners. This statement includes, among other relevant data, the income, disbursements, reserves, etc., in respect to policies issued to persons resident in the United States at the time of issue, even though some of these policyholders may subsequently become residents outside the United States. It also includes, under the heading of "Assets," in addition to policy assets, the statutory deposits and trusteed assets required to match U.S. policy liabilities. The investment income from all such assets is, of course, also reported in the statement.

Because of the need for classification of taxable income under the proposed new tax procedure, we urge that either the law or the regulations should expressly provide that income effectively connected with the conduct of any trade or business within the United States, in the case of a foreign life insurance company, will be basically that reported in the annual statement of the U.S. business of such company on the NAIC form.

The need for a special provision of this kind for our companies, beyond the definition in new section 864(c), arises on two counts in particular—

(*a*) Foreign life insurance companies seem to be the only foreign corporations of any kind whose taxable income is subject to a special adjustment, as under existing 819(b), and for this reason the definition of our effectively connected income should not necessarily follow the usual rules;

(*b*) Our companies, along with life insurance companies generally, are to be distinguished from most other types of corporations in regard to their major function as investors in securities of substantial funds. Because of this, our companies have income from extensive investments in the United States. The major portion of such investment income would arise from investments in the United States in connection with U.S. business. However, our companies have additional investments in the United States held in relation to liabilities arising from non-U.S. business. The income from these investments is not connected with U.S. business.

State insurance laws require foreign life insurance companies to maintain assets on deposit with approved trustees or State officials in the United States sufficient, at market value, to cover liabilities to U.S. policyholders and creditors. Only such deposited assets can be identified, by the company or others concerned, as being effectively connected with U.S. business. Furthermore, the operation of the minimum surplus requirement of section 819(b) insures, for income tax purposes, the adequacy of the amount of such deposited assets. Such assets are, of course, those reported in the aforementioned annual statement. We feel it is imperative, therefore, that there be a clear provision identifying income effectively connected as that reported in the annual statement of U.S. business. It seems only reasonable to us that such definite guidelines should be spelled out either in the law or regulations.

With income effectively connected clearly defined, as suggested in the foregoing, income from sources within the United States from investments in the United States not included in the annual statement of U.S. business, would fall automatically to be classified as income not connected and be taxable as provided in proposed section 881. With respect to this income not connected, our position taxwise would be the same as in the case of a foreign corporation not engaged in trade or business in the United States in receipt of similar income from sources within the United States.

(*b*) *Settlement of proposed section 881 tax*

Under proposed section 1442, the tax imposed by new section 881 would be collected by deduction and withholding at the source. Our companies will be in receipt of investment income as defined in new section 881, from sources within the United States arising from both deposited and nondeposited assets. The income from the former being effectively connected will not be subject to withholding. With respect to the latter, the income being not connected would normally be subject to withholding of tax at the source. Because of this situation, we foresee problems with respect to the application of withholding of tax at the source, and particularly so since not infrequently some issues of bonds and shares might be partly deposited and partly not deposited. Because of the volume involved, it would be complicated and costly for our companies to keep the payers of interest and dividends advised as to when withholding applied and when it did not.

To avoid these difficulties, we suggest that in the case of our companies and for others where a comparable problem existed, provision be made for settlement of the tax annually rather than by withholding. This could be done by means of a return filed annually in which such investment income as defined in new section 881 would be reported.

This could possibly be done by a provision in the statute, under which the Secretary of the Treasury would be given authority to vary the withholding requirements of section 1442 where, in his judgment, circumstances warranted it.

A similar situation exists with respect to U.S. life insurance companies subject to withholding tax in Canada. Under the authority of section 109(4) of the Canadian Income Tax Act, regulations (800–804) were made in 1953 whereby the withholding provisions were made inapplicable in the case of such companies and requiring them to file an annual return and make an annual settlement of the tax.

Annual settlement in this way of the tax payable under new section 881 would, we feel, also provide a simple and convenient means for making any adjustments found necessary by reason of any overlap, due to the operation of the minimum surplus requirement of section 819(a), of tax payable under new section 842.

(*c*) *Adjustment of proposed section 881 tax for any overlapping due to the operation of the minimum surplus provision of section 819*

Overlapping of tax may occur when tax payable under new section 842 involves an adjustment by reason of the operation of the minimum surplus requirement of section 819, in the case of a company subject to tax on income not effectively connected under proposed section 881. To avoid double taxation where any such overlapping occurs, we suggest that provision be made for an adjustment in taxes payable under proposed section 881.

For the purposes of such an adjustment, provision might be made for reducing the tax payable under proposed section 881, in the ratio which the amount of the adjustment resulting from the operation of the minimum surplus provision of section 819 bears to the amount of income, including any tax exempt income, as defined in proposed section 881 provided that the said ratio should never exceed unity and provided further that the reduction in tax should not exceed the additional tax payable under section 842, by reason of the operation of the section 819 adjustment.

In the previous paragraph, the first proviso would insure that the reduction in tax would never exceed the tax payable under new section 881, and the second proviso would preclude any reduction in tax in excess of the additional tax incurred under new section 842 by reason of the operation of the minimum surplus provision of section 819.

THE MANUFACTURERS LIFE INSURANCE CO.,
Toronto, Canada, January 27, 1966.

Re H.R. 11297, Foreign Investors Tax Act of 1965.

DR. LAURENCE N. WOODWORTH,
Chief of Staff, Joint Committee on Internal Revenue Taxation, Washington, D.C.

DEAR DR. WOODWORTH: With my letter of January 19, I sent you a memorandum dealing with some provisions of this bill which present special problems for Canadian life insurance companies doing business in the United States.

As a supplement to that memorandum, we have prepared draft revisions of a few sections of the bill which would give effect to the suggestions made in the memorandum. This draft has been prepared in the hope that it may be of some assistance to you if the bill is to be revised for this purpose.

Three copies of our draft are attached, and include the following material:

Section 819(a).—A new subsection suggested to define the effectively connected income to be taxed under part 1 of subchapter L. To avoid interpretative and administrative difficulties in future, as previously expressed, if at all possible it would be most desirable to include some provision on this point in the proposed bill. If this is not possible, we would hope that some provisions substantially as suggested would be included in the committee report and regulations.

Section 819(b)(3).—A new subparagraph dealing with the reduction of section 881 tax for the overlap referred to in our memorandum. Presumably, any provision on this point should be included in the bill itself, inasmuch as the 819(b)(1) adjustment was included in full detail in the 1959 act.

Section 819(b) (1) and (2) and section 819(c).—Minor changes intended only to make the language conform more closely to that used in the other sections of our draft.

Section 1442.—A new subsection (b) is suggested to permit exemption from withholding.

Section 842 and section 894.—Included as possibly suggesting some clarification of the intent of the sections of the proposed bill.

Please be assured that we very much appreciate the cooperation you have extended to us. If further information or discussion would be helpful to you in any way, we would be glad to have the opportunity to send you a further memorandum or to meet with you again.

Sincerely,

(S) E. C. Robinson,
Associate Secretary.

Per favor of Mr. Kenneth L. Kimble, vice president and general counsel, Life Insurance Association of America, Washington, D.C.

SECTION 819. FOREIGN LIFE INSURANCE COMPANIES

(a) Carrying on United States Insurance Business.—In the case of any foreign corporation carrying on a life insurance business within the United States, if with respect to its trade or business conducted within the United States it would qualify as a life insurance company under section 801,

(1) all computations entering into the determination of its income effectively connected with its conduct of its trade or business within the United States and the determination of the tax payable thereon under this part shall be made, except as otherwise provided in this part, on the basis of the income, disbursements, assets, liabilities, and surplus reported in the annual statement for the taxable year of the United States business of such company in the form prescribed by the National Association of Insurance Commissioners, and

(2) the acquisition and holding for investment purposes only of stocks, bonds, mortgages, or other securities, land or other property, which are not reported in such annual statement, and the collection of investment income therefrom and the sale and reinvestment of the proceeds thereof, shall not constitute the conduct of a trade or business.

(b) ADJUSTMENT WHERE SURPLUS ON UNITED STATES INSURANCE BUSINESS IS LESS THAN SPECIFIED MINIMUM.—

(1) IN GENERAL.—In the case of any foreign corporation described in subsection (a), if the minimum figure determined under paragraph (2) exceeds the surplus on its United States insurance business, then—

(A) the amount of the policy and other contract liability requirements (determined under section 805 without regard to this subsection), and

(B) the amount of the required interest (determined under section 809(a)(2) without regard to this subsection),

shall each be reduced by an amount, hereinafter referred to as the amount of the adjustment, determined by multiplying such excess by the current earnings rate (as defined in section 805(b)(2)).

(2) DEFINITIONS.—For purposes of paragraph (1)—

(A) The minimum figure is the amount determined by multiplying the taxpayer's total insurance liabilities on United States insurance business by—

(i) in the case of a taxable year beginning before January 1, 1959, 9 percent, and

(ii) in the case of a taxable year beginning after December 31, 1958, a percentage for such year to be determined and proclaimed by the Secretary or his delegate.

The percentage determined and proclaimed by the Secretary or his delegate under clause (ii) shall be based on such data with respect to domestic life insurance companies for the preceding taxable year as the Secretary or his delegate considers representative. Such percentage shall be computed on the basis of a ratio the numerator of which is the excess of the assets over the total insurance liabilities, and the denominator of which is the total insurance liabilities,

(B) The surplus on United States insurance business is the excess of the assets reported for such taxpayer's United States insurance business over the total insurance liabilities on such business.

For purposes of this paragraph and subsection (c), the term "total insurance liabilities" means the sum of the total reserves (as defined in section 801(c)) plus (to the extent not included in total reserves) the items referred to in paragraphs (3), (4), and (5) of section 810(c).

(3) REDUCTION OF SECTION 881 TAX.—In the case of any foreign corporation described in subsection (a), there shall be determined—

(A) the amount of the income, prior to exemption of tax-exempt interest, which without regard to this paragraph or to such exemption would be subject to tax under section 881, and

(B) the amount of the adjustment referred to in paragraph (1) or the amount referred to in subparagraph (A) of this paragraph, whichever is the lesser, and

(C) the excess, if any, of the amount of tax payable under this part over the amount which would be payable if such tax were computed without regard to the minimum surplus adjustment provided in paragraph (1).

The amount of tax determined without regard to this paragraph under section 881 (after giving effect to allowable exclusions and exemptions and to any treaty obligation of the United States) shall be reduced by an amount which is the same proportion of such tax as the amount referred to in subparagraph (B) is of the amount referred to in subparagraph (A), but the amount of such reduction shall not be greater than the amount of the excess referred to in subparagraph (C).

(c) DISTRIBUTION TO SHAREHOLDERS.—

(1) IN GENERAL.—In applying sections 802(b)(3) and 815, with respect to a foreign corporation described in subsection (a), the amount of the distributions to shareholders shall be determined by multiplying the total amount of the distributions to shareholders (within the meaning of section 815) of the foreign corporation by whichever of the following percentages is selected by the taxpayer for the taxable year:

(A) the percentage which the minimum figure for the taxable year (determined under subsection (b)(2)(A)) is of the excess of the assets of the company over the total insurance liabilities; or

(B) the percentage which the total insurance liabilities on United States insurance business for the taxable year is of the company's total insurance liabilities.

(2) DISTRIBUTIONS PURSUANT TO CERTAIN MUTUALIZATIONS.—In applying section 815(e) with respect to a foreign corporation described in subsection (a)—

(A) the paid-in capital and paid-in surplus referred to in section 815(e)(1)(A) of such foreign corporation is the portion of such capital and surplus determined by multiplying such capital and surplus by the percentage selected for the taxable year under paragraph (1); and

(B) the excess referred to in section 815(e)(2)(A)(i) (without the adjustment provided by section 815(e)(2)(B)) is whichever of the following is the greater:

(i) the minimum figure for 1958 determined under subsection (b)(2)(A), or

(ii) the surplus described in subsection (b)(2)(B) (determined as of December 31, 1958).

SUGGESTED REVISION OF SECTION 842

SEC. 842. FOREIGN CORPORATIONS CARRYING ON INSURANCE BUSINESS.

If a foreign corporation carrying on an insurance business within the United States would qualify with respect to its trade or business conducted within the United States under part I, II or III of this subchapter for the taxable year if it were a domestic corporation, it shall be taxable under such part (and not under section 882) on its income effectively connected with its conduct of any trade or business within the United States. With respect to the remainder of its income which is from sources within the United States, such a foreign corporation shall be taxable as provided in section 881.

(Explanation: H.R. 11297, as introduced, includes a wording in section 842 that seems to assume that the qualification test can be made solely on the basis of income. Since the qualification tests actually depend on other elements of the operation, for example, reserves, we have suggested a wording that may be more satisfactory. We have also included in brackets the words "and not under section 882", to underline the intent of section 842. We do not think the above draft alters the intent of section 842 in any way.)

SEC. 894. INCOME AFFECTED BY TREATY.

(a) INCOME EXEMPT UNDER TREATY.—Income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

(b) PERMANENT ESTABLISHMENT IN UNITED STATES.—For purposes of applying, with respect to income which is not effectively connected with the conduct of a trade or business within the United States, any exemption from, or reduction of any tax provided by any treaty to which the United States is a party, a nonresident alien individual or a foreign corporation shall be deemed not to have a permanent establishment in the United States at any time during the taxable year. This subsection shall not apply in respect of the tax computed under section 877(b).

(Explanation: In line 5 of subsection (b) above the word "a" has been added before "foreign corporation" to remove any possible misinterpreation of the existing wording to mean nonresident foreign corporation. This is in accordance with our understanding of the intent of section 894.)

SEC. 1442. WITHHOLDING OF TAX ON FOREIGN CORPORATIONS

(a) In the case of foreign corporations subject to taxation under this subtitle there shall be deducted and withheld at the source in the same manner and on the same items of income as is provided in section 1441 or section 1451 a tax equal to 30 percent thereof; except that, in the case of interest described in section 1451 (relating to tax-free covenant bonds), the deduction and withholding shall be at the rate specified therein. For purposes of the preceding sentence, the reference in section 1441(c)(1) to section 871(b)(1) shall be treated as referring to section 842 or 882(a) as the case may be.

(b) Under regulations prescribed by the Secretary or his delegate, any items of income payable to a foreign life insurance company taxable under part 1 of subchapter L may be exempted from deduction and withholding under subsection (a).

MANUFACTURING CHEMISTS' ASSOCIATION, INC.
Washington, D.C., February 23, 1966.

HON. WILBUR D. MILLS,
Chairman, Ways and Means Committee, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: This letter is being sent to you on behalf of the Manufacturing Chemists' Association (MCA), a nonprofit trade association including 192 U.S. member companies, large and small, which together account for more than 90 percent of the country's productive capacity for chemicals.

Our association has reviewed H.R. 11297, the Foreign Investors Tax Act of 1965, introduced by you last year. We understand the purpose of this bill is to remove tax barriers to investment in the United States by foreigners and thereby contribute to an improvement in our balance of payments.

Although the predecessor bill, H.R. 5916, was the subject of public hearings before your committee in 1965, that bill did not contain the new concept which would be incorporated in section 882 of the Internal Revenue Code that foreign corporations engaged in trade or business in the United States would be taxed on all of their income which is "effectively connected" with the conduct of such trade or business. We are seriously concerned with this new concept in that it represents a very significant change from the past basis upon which foreign corporations engaged in trade or business in the United States were taxed.

We believe that it would be quite helpful to your committee and taxpayers alike if public hearings were held on this new provision in H.R. 11297, and we would like to respectfully request that this be done.

Sincerely,

G. H. DECKER, *President.*

MORGAN GUARANTY TRUST CO. OF NEW YORK,
New York, N.Y., January 31, 1966.

Hon. WILBUR MILLS,
Chairman, House Ways and Means Committee,
House of Representatives, Washington, D.C.

DEAR MR. MILLS: I understand that your committee is holding hearings currently concerning H.R. 11297, the so-called Foreign Investors Tax Act. There are some parts of this bill as presently written which we believe would be detrimental to the U.S. balance of payments, if passed. I enclose a memorandum which outlines the reasons we think it would have this effect.

I understand that Mr. Thornton D. Strecker, deputy comptroller of this bank, outlined verbally our thoughts to Mr. L. M. Woodworth of your staff last week, but if we can supply any further information we would be pleased to do so.

Sincerely,

THOMAS S. GATES,
Chairman of the Board.

MEMORANDUM: POSITION OF MORGAN GUARANTY TRUST CO. OF NEW YORK ON PROPOSED H.R. 11297, THE FOREIGN INVESTORS TAX ACT OF 1965

There are three proposals in the above bill which in our view will have a serious adverse effect on the U.S. balance of payments:

(1) Proposed imposition of income tax (and withholding thereof) on interest received by nonresident aliens, foreign cor-

porations, and banks other than foreign central banks, not doing business in the United States, on U.S. dollar deposits in the domestic offices or foreign offices of U.S. banks;

(2) Proposed estate tax on U.S. dollar deposits of nonresident aliens not doing business in the United States at the time of death where such deposits are held in the domestic offices or foreign offices of U.S. banks;

(3) The proposed change to subject to Federal estate tax bonds issued by the U.S. government, political subdivisions thereof, and U.S. corporations when owned by nonresident aliens not doing business in the United States even where these bonds were located outside the United States at time of death.

The proposed change mentioned in (1) above seems to us of major importance. Based on published statistics of the Federal Reserve System and the U.S. Treasury as of September 30, 1965, foreign individuals, foreign corporations, and foreign commercial banks held over $2 billion in time deposits in the domestic offices of U.S. banks. It is hard to believe that a very large part of these deposits would not be quickly withdrawn if made subject to income tax on a withholding basis. It is true that perhaps part of these funds will continue to be held by their owners in dollars with foreign banks in such leading Euro-currency markets as London and that the dollars will then be carried as current dollar deposits with U.S. correspondents of these foreign banks. However, we believe that there would be an increased tendency on the part of the owners of such dollars to swap or convert them to other currencies. Both of these actions would probably have the effect of changing unofficial claims on the United States to official claims by central banks and thereby pose a threat to the U.S. gold reserve.

We know of no available nationwide statistics giving deposits in foreign branches of U.S. banks. However, the Bank of England reports that at the end of September 1965 American banks held deposits from non-United Kingdom depositors equivalent to $2.7 billion; we believe it reasonable to assume that about $1.5 billion of these deposits were interest-bearing dollar deposits from foreign individual and corporate, including bank (other than central bank), sources. We would also estimate that there was another $0.5 billion of such interest-bearing dollar deposits in foreign branches of U.S. banks outside of the United Kingdom. A good proportion of these funds is presently redeposited by the foreign branches of the U.S. banks with their head offices. Another large percentage of these funds is loaned by these foreign branches to U.S. corporations to enable the latter to finance their businesses abroad without hurting the U.S. balance of payments. Imposition of an income tax on these deposits we feel would mean that they would quickly disappear from the branches of the U.S. banks going to foreign banks operating into the Euro-currency markets. Again some of these funds would be held as current dollar deposits by these foreign banks with their correspondents in the United States, but there would be a tendency to swap or to sell outright these funds for foreign currencies, changing their status to an official claim against the United States. The foreign banks would not be as likely to channel as great a proportion of their funds to help financing of subsidiaries of U.S. corporations abroad as would American branch banks. We believe also that the proposed tax would have the effect of relegating the foreign branches of the U.S. banks to minor factors in the Euro-currency markets thereby reducing their foreign earnings which are a credit to the balance of payments and a source of U.S. income tax revenue.

The proposed estate tax mentioned under (2) above would be put into effect immediately and would, we believe, force withdrawal of a very large proportion of the foreign individual deposit accounts in U.S. banks, both those held in their domestic offices and those in their foreign branches. We know of no source which gives the amount of the deposits of foreign individuals but we think they are a sizable part of the $2 billion estimate given above as a total of deposits in the domestic offices of U.S. banks of foreign individuals, corporations, and banks (other than central banks) not doing business in the United States. They are probably a smaller percentage of the $2 billion total of such deposits held by *foreign* branches of U.S. banks. In the past these deposits of foreign individuals have been held by the U.S. banks both in the United States and abroad because of the stability of the U.S. dollar and of the banks which have their capital in this currency. This factor has been enough to overcome certain advantages offfered by foreign banks often including a higher interest rate for U.S. dollar deposits. However, we believe that an estate tax on these deposits would quickly force foreign depositors to other depositories for their funds. Estate administration in the United States is difficult and expensive for nonresident aliens. The simplicity under present law of transfer of bank deposits through the means of a joint account without the necessity of filing tax returns is important to their heirs. Inclusion of bank deposits in the taxable estate would add administrative complications as an additional deterent to alien bank deposits in the United States.

Point (3) above requires no extensive comment. A provision to include additional intangibles in the taxable estate of nonresident alien certainly has no place in a bill designed to aid the U.S. balance of payments by encouraging investment in the United States.

For the foregoing reasons it is a certainty, if this bill is passed as written, that U.S. banks will not only fail to attract further cash deposits from nonresident alien individuals and foreign corporations not doing business in the United States, but is an equal certainty that American banks will lose a substantial portion of their present deposits from these customers. Obviously loss of all or part of $4 billion deposits in U.S. banks will have a major effect on the U.S. balance of payments. Although in lesser amounts the same effect would be produced as regards to individual accounts as a result of the proposed immediate imposition of the *estate tax*, regardless of whether or not the payment of income tax on interest earned is deferred until 1971.

The bill likewise contains administrative problems for the nonresident alien, the Internal Revenue Service and withholding agents. Section 3(h) of the above bill amends section 1461 of the Internal Revenue Code by eliminating the provision in that section for the filing of withholding tax returns and the payment of tax by March 15 of each succeeding year. The presumption is that quarterly returns accompanied by the payment of tax will be required. This will represent a substantial increase in the amount of work involved in handling tax withholding returns and payments to the Internal Revenue Service. Instead of one annual return, a withholding agent will presumably be faced with the prospect of preparing and filing withholding returns four times each year.

It should also be noted that with respect to nonresident alien trust beneficiaries, withholding is initially accomplished on the basis of remittances made to them. Since principal account deductions enter into the computation of "distributable net income" the total amount of taxable income from U.S. sources is not known until after the close of the taxable year. In most cases there will be an excess withheld which, under present procedures, is refunded to the beneficiary before the tax is paid to the Internal Revenue Service on March 15. If the full amount of tax is to be paid currently, the beneficiaries will be required to file U.S. income tax returns and claims for refund to obtain the excess amounts withheld. Accordingly, both nonresident alien taxpayers and the Internal Revenue Service will be put to additional labor and expense.

Furthermore, tax treaties that are negotiated and finalized within a given year often provide that the new rates are retroactive to the preceding January 1. Regulations have usually authorized withholding agents to refund any excess withholding. If the tax had already been paid to the Internal Revenue Service, any adjustments would have to be made by the Service after application by the nonresident alien.

Having stated our principal objections to H.R. 11297 as introduced, we should add one favorable comment coupled with a recommendation for further improvement. The bill introduces a long-needed change in the source of income rules by including as foreign source income interest paid on deposits in foreign branches of American banks, regardless of the nationality or business connection with the United States of the recipient. However, the change is limited to deposits payable in foreign currency; interest on dollar deposits remains subject to the same source rules as deposits in the United States.

It is recommended that the treatment as foreign source income of interest paid by foreign branches of American banks be extended to include interest paid on dollar deposits, as well as on foreign currency deposits as proposed in H.R. 11297. Interest received from a foreign bank is foreign source income, whether paid on foreign currency or dollar deposits. Any provision of U.S. law which places a foreign branch of an American bank at a disadvantage in competing for deposits with its foreign bank competitors is likely to result in a net loss of revenue to the U.S. Treasury, and more important to U.S. balance-of-payments considerations, will drive deposits from the U.S. banking system into foreign banking systems where among other things, they could become a claim on our gold, as noted above.

To summarize, it is our view that there are serious imperfections in H.R. 11297 if its purpose is to benefit the U.S. balance of payments. We believe it would not only fail to encourage foreign investment in the United States; it would actually deter such investment and increase the likelihood of gold withdrawals. Accordingly, we strongly urge a return to the basic recommendations of the Presidential task force under the chairmanship of Secretary of the Treasury Fowler, then Undersecretary of the Treasury, one of which was the elimination of

U.S. estate taxes on all intangible personal property of nonresident alien decedents. Those recommendations in our opinion were not only soundly conceived but realistic as well in terms of the problem to be solved. The proposal in H.R. 11297 to tax U.S. bank interest paid to nonresident aliens and foreign corporations not doing business in the United States (for the first time since the Revenue Act of 1921) is completely contrary to the recommendations of the task force and should be eliminated.

With respect to potential administrative problems created alike for the Internal Revenue Service, withholding agents and aliens by elimination of annual reporting and payment of withheld taxes, and presumably the ultimate substitution of quarterly reports, these problems probably have relatively little effect on balance of payments, and opposition to this provision is obviously secondary in importance to the other stated objections to H.R. 11297. However, the needless introduction of new administrative problems has no relationship to the stated purposes of the bill and should be eliminated.

On the other hand, treatment as foreign source income of interest paid on foreign currency deposits in foreign branches of American banks is a step in the right direction toward tax equality between foreign banks and American branch banks in competing for deposits abroad, and similar treatment for interest paid on dollar deposits would be even more beneficial to the balance of payments in retaining and attracting dollars to the American banking system.

WALTER H. PAGE,
Executive Vice President.

MOSES & SINGER,
New York, N.Y., December 23, 1965.

Re Foreign Investors Tax Act of 1965 (H.R. 11297).

Hon. WILBUR D. MILLS,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR CHAIRMAN MILLS: Reference is made to section 4 of the proposed Foreign Investors Tax Act of 1965 (H.R. 11297) in which it is proposed to amend paragraph (7) of section 542(c) of the Internal Revenue Code of 1954, relating to corporations not subject to the personal holding company tax, as follows:

"(7) A foreign corporation, if all of its stock outstanding during the last half of the taxable year is owned by nonresident alien individuals, whether directly or indirectly through foreign estates, foreign trusts, foreign partnerships, or other foreign corporations;".

It is submitted that the jurdisdiction in which a corporation is incorporated should be irrelevant in an income tax system concerned with substance and not with form. On a parity of reasoning with that underlying the proposed amendment concerning the exemption from the personal holding company tax of foreign corporations with certain foreign shareholders, a similar exemption provided for *domestic* corporations with foreign shareholders and solely investment income. If this were done, foreigners wishing to invest in American stock and securities would be able to do so through the vehicle of a corporation incorporated under the laws of any of the States of the United States as well as one incorporated in the Bahamas, Panama, Switzerland, Lichtenstein, etc. The suggested technical amendment would have no adverse effect on the U.S. Treasury, but would permit foreigners wishing to invest in U.S. stock and securities to do so through a U.S. corporation as well as a foreign entity, and, if they chose a U.S. entity, it would give the United States a greater degree of supervision over the activities of such investors and gain revenue for the various States in which such corporations are incorporated. Finally, and most important, it would subject such domestic corporations to the regular U.S. income tax, thereby gaining revenue for the Treasury.

I trust you and your committee will favorably consider the foregoing technical amendment.

If you or your committee have any questions concerning the foregoing, please feel free to contact the undersigned.

Yours very truly,

BURTON JOEL AHRENS.

NATIONAL FOREIGN TRADE COUNCIL, INC.,
New York, N.Y., February 4, 1966.

Re Foreign Investors Tax Act of 1965 (H.R. 11297).

Hon. WILBUR D. MILLS,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: You will recall my letter to you of January 14, 1966, and the accompanying memorandum concerning H.R. 11297.

In order to insure that there is no misunderstanding, I want to take this opportunity to point out that our comments beginning on page 4 pertaining to interest paid to nonresident aliens and foreign corporations on U.S. bank deposits apply also to savings and loan associations and amounts deposited with insurance companies. I have particular reference to the last paragraph on page 5 and the first paragraph on page 6.

Sincerely yours,

ROBERT J. KELLIHER,
Chairman, Tax Committee.

NATIONAL FOREIGN TRADE COUNCIL, INC.,
New York, N.Y., January 14, 1966.

Re Foreign Investors Tax Act of 1965 (H.R. 11297).

Hon. WILBUR D. MILLS,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: When the Foreign Investors Tax Act of 1965, H.R. 11297, was introduced, it was indicated that comments received would be reviewed by the Ways and Means Committee before the bill is reported to the House in the next session of Congress.

The National Foreign Trade Council had commented on the earlier bill in a letter to you dated July 7, 1965, indicating a general approval of that bill as being in accord with the legislative recommendations of the Fowler Task Force, which had been appointed to advise on ways in which more U.S. securities could be sold abroad to help meet the balance-of-payments problem. Three recommendations for changes in H.R. 5916 were submitted to you at that time.

The National Foreign Trade Council has reviewed H.R. 11297 from the standpoint of the stated policy of the report of the Fowler Task Force. The present bill, like the earlier bill, would make important changes in U.S. taxation of foreign investors in U.S. securities which should help to encourage investments in the United States. However, certain other changes made in the later bill would appear to be contrary to the general policies set forth in the report of the Fowler Task Force. These changes are as follows:

1. The increases in the estate tax rates on nonresident individuals, as compared with those in H.R. 5916, and the inclusion in the taxable estate of bank deposits owned by nonresident alien individuals not engaged in trade or business in the United States, tend to work contrary to the purpose of this legislation.

2. The taxation of interest on bank deposits received after 1970 by nonresident alien individuals and foreign corporations not engaged in trade or business in the United States eliminates from our law a longstanding inducement to the making of such investments in the United States.

3. The proposal to tax nonresident aliens and foreign corporations engaged in trade or business in the United States on income from sources outside of the United States, if it is "effectively connected" with the U.S. trade or business, is a radical extension of the existing scope of our tax law. Its effect would be contrary to the purposes of this bill. It is a major change of policy which the council believes is unwarranted and at least deserves careful and separate consideration. It is in conflict with most treaties with regard to the taxation of U.S. branches of foreign companies, and therefore would be inoperative in those cases.

These matters are discussed in somewhat greater detail in the attached memorandum.

The Fowler Task Force did not recommend the elimination of U.S. withholding tax on dividends and interest paid to nonresident alien individuals and foreign corporations, apparently because of the expected reduction of revenue and the possible adverse effect on the bargaining power of the United States in treaty negotiations. However, elimination of the tax would be a major incentive to foreign investment in the United States which might well justify the loss of revenue, and the President's power under proposed section 896 to reinstate existing income tax provisions, would preserve the treaty bargaining power. The National Foreign Trade Council therefore suggests that your committee consider the elimination of tax on dividends and interest paid to nonresident aliens and foreign corporations, if such interest is not effectively connected with a trade or business in the United States.

The National Foreign Trade Council believes that the foregoing matters are sufficiently important that hearings should be held on this bill before it is submitted to the House of Representatives in the current session of Congress.

Sincerely yours,

ROBERT J. KELLIHER,
Chairman, Tax Committee.

THE FOREIGN INVESTORS TAX ACT OF 1965

The Foreign Investors Tax Act of 1965, introduced shortly before Congress adjourned, makes three changes which seem to the National Foreign Trade Council to be contrary to the legislation's original intent. This bill, H.R. 11297, grew out of recommendations of the Fowler Task Force for changes in taxation of foreign investors to improve the U.S. balance of payments by stimulating foreign investment in the United States. An earlier version of the proposed legislation, H.R. 5916, was found to be generally in line with the original recommendations. But the current version, H.R. 11297, proposes changes which, by comparison with the earlier version of the bill or the original recommendations of the Fowler Committee, must be viewed as backward steps in three respects: increased estate tax rates for nonresident alien decedents, and inclusion of certain intangible property presently excluded from their estate tax base; introduction of a novel concept with regard to taxation of nonresident aliens and foreign corporations engaged in trade or business in the United States; and the introduction of income taxation of interest on U.S. bank deposits owned by nonresident aliens and foreign corporations not doing business in the United States.

RECOMMENDATIONS OF THE "FOWLER TASK FORCE"

The Presidential task force, appointed to study ways to improve the U.S. balance of payments by stimulating foreign investment, produced many recommendations, including several for changes in U.S. tax laws. Among the tax recommendations were—

(1) "Eliminate U.S. estate taxes on all intangible personal property of nonresident alien decedents."

(2) "Provide that a nonresident alien individual engaged in trade or business within the United States be taxed at regular rates only on income connected with such trade or business." This change would give such persons the benefit of the generally lower rates of U.S. taxation of investment income. (The graduated rates on income over $19,000 were also to be eliminated.)

H.R. 5916

On March 8, 1965, H.R. 5916 was introduced. The National Foreign Trade Council concluded that the bill generally followed the Fowler report recommendations, except that estate tax rates were reduced to a maximum of 15 percent rather than eliminated. The estate tax exemption was increased from $2,000 to $30,000.

In its comments on H.R. 5916, the National Foreign Trade Council recommended that the most desirable change which might be made in that bill would be to return to the original recommendation of the

Fowler task force; namely, to "eliminate U.S. estate taxes on all intangible personal property of nonresident alien decedents."

Another recommendation made by the Council at that time was to make it clear that nonresident alien individuals who were not engaged in trade or business within the United States should not be required to file income tax returns provided, of course, that their tax had been satisfied by withholding at source. It also recommended that foreign security dealers should be encouraged to participate in the marketing to foreigners of U.S. securities by modifying the definition of the term "engaged in trade or business within the United States." This would permit these dealers to participate in such marketing without being treated as engaged in trade or business in this country.

H.R. 11297

U.S. estate tax

As compared with H.R. 5916, this bill would increase estate tax rates on estates of nonresident aliens to a maximum of 25 percent, thus giving less incentive for foreign investment in the United States than was given by H.R. 5916.

H.R. 11297 would include in the taxable estate of a nonresident alien certain intangible personal property which is excluded from the estate under present law. Such property includes (*a*) bank deposits of a nonresident alien not engaged in business in the United States, and (*b*) debt obligations of a U.S. person (including a U.S. corporation), the United States, a State or political subdivision of a State, or the District of Columbia, even though such obligations are physically located abroad. There is no doubt that these provisions will have an adverse effect on foreign investment in the United States.

Interest paid to nonresident aliens and foreign corporations on U.S. bank deposits

Since the Revenue Act of 1921, interest on deposits with persons carrying on the banking business paid to persons not engaged in trade or business within the United States has been treated as foreign source income and consequently not subject to U.S. income tax. In considering the merits of this exclusion from taxable income, the House Ways and Means Committee report (67th Cong., 1st sess.) indicated that "the loss of revenue which would result if this deduction were allowed would be relatively small in amount, while the exemption of such interest from taxation would be in keeping with the action of other countries and would encourage nonresident alien individuals and foreign corporations to transact financial business through institutions located in the United States." H.R. 11297 would completely change this long standing rule of law in that interest paid on bank deposits to nonresident aliens and foreign corporations after December 31, 1970, will become subject to income tax even though the recipient may not be doing business in the United States. The technical change in source definitions made by the bill affecting bank interest during the interim period 1966 through 1970 is not objectionable since it is not less favorable than existing law in its treatment of U.S. bank interest paid to foreigners.

It is submitted that the factors prevailing in today's economy are even more compelling than in the 1920's in requiring that interest paid on U.S. bank deposits to nonresident alien individuals and foreign corporations not doing business in the United States continue to be exempt from U.S. taxation. The U.S. balance-of-payments problem would be made more acute if this interest were taxed since it seems reasonable to believe that a substantial part of the underlying deposits would be transferred to foreign banks. If this were to happen there would be an increased likelihood of these dollars shifting from private to public hands and then becoming a claim on our gold. In addition, it is evident there would be no gain in U.S. tax revenue but in fact a loss, since the shifting of these deposits to foreign banks not subject to U.S. taxation would reduce taxable income otherwise generated by U.S. banks on these deposits.

H.R. 11297 is intended to encourage foreign investment in the United States by removing tax barriers to such investment, thereby beneficially affecting the U.S. balance of payments. To quote Secretary Fowler in his report to the President of the United States from the Task Force on Promoting Increased Foreign Investment in U.S. Corporate Securities and Increased Foreign Financing for U.S. Corporations Operating Abroad, "The United States should, however, first attempt to attract foreign investment by attacking the several areas of taxation that deter investment without generating material revenues." The proposed estate tax treatment of U.S. bank deposits and the proposed income taxation of bank interest after 1970 are completely inconsistent with these purposes and will undoubtedly lead to the withdrawal of funds presently employed in our economy.

The NFTC does not object to the proposed treatment of U.S. bank interest paid to nonresident aliens and foreign corporations between January 1, 1966, and December 31, 1970, which in effect continues the exemption which has existed since 1921, and strongly recommends that this treatment be continued in respect of such interest paid after December 31, 1970.

Interest paid to nonresident aliens and foreign corporations on foreign currency deposits with foreign branches of U.S. banks

Under current law, interest on foreign currency deposits with foreign branches of U.S. banks is exempt from U.S. income tax only if the recipient is not doing business in the United States. The proposed bill would categorize such interest as being from foreign sources and thus exempt from U.S. tax if not effectively connected with a U.S. trade or business.

The NFTC agrees with the proposed treatment as foreign source income of interest paid on foreign currency deposits with foreign branches of U.S. banks, and strongly urges that interest paid by such branches on U.S. dollar deposits should be accorded the same treatment. Any provision of U.S. tax law which places a foreign branch of a U.S. bank at a competitive disadvantage with a foreign bank can only result ultimately in a loss to the U.S. Treasury and will drive these dollar deposits outside of the U.S. banking system. Transfer of dollar deposits from the U.S. banking system to foreign banks makes them vulnerable to a demand for conversion into gold, as noted above.

NEW TAX CONCEPT—"EFFECTIVELY CONNECTED"

One of the recommendations of the Fowler Committee was that foreign investors who are engaged in trade or business in the United States should nevertheless be entitled to have their U.S.-source-investment income taxed at the same rates as persons who were not so engaged. In H.R. 11297, there are provisions to segregate and separately tax investment income and noninvestment income. However, the bill also contains a provision under which the tax on nonresident aliens and foreign corporations will be extended to sources outside the United States if it is "effectively connected" with their U.S. trade or business.

The principle of taxing foreign corporations only on their U.S.-source income is so fundamental in existing law that the proposed change requires many collateral amendments of the code. While the bill makes amendments to the provisions relating to foreign tax credits and dividends-received deductions, these changes are so complex that extended study would be required to determine whether these changes are all that are necessary and to evaluate the importance of the cases in which there may not be complete alleviation of double taxation as a result of the changes.

The introduction of this concept could result in a radical change in the paterns of U.S. taxation of foreign corporations owned by U.S. corporations and individuals. The language which is contained in the proposed revision of the bill could be interpreted to enable the imposition of U.S. income taxes on foreign subsidiaries of U.S. corporations which have relatively minor activities on the part of officers of the foreign subsidiary or officers of the parent corporation on behalf of the subsidiary. Such a change is undesirable and seems unnecessary in light of the major review and overhaul of the taxation of such corporations undertaken in the Revenue Act of 1962.

The introduction of such a novel concept as taxing foreign persons on their income from sources without the United States seems inappropriate in this legislation because it is not connected with the primary purpose of the bill.

Approximately three-quarters of our income tax treaties provide that where a foreign corporation has a permanent establishment in the United States such permanent establishment is subject to tax only on its U.S.-source income attributable to the permanent establishment.

The term "effectively connected" is not defined in the bill, but instead, proposed section 864(c) merely cites three factors which should be taken into account in determining whether gains, profits, and income or loss shall be treated as "effectively connected" with the conduct of a trade or business within the United States.

It is considered that the lack of a clear definition of "effectively connected" would tend to discourage U.S. investment. Nonresident aliens and foreign corporations in trade or business in the United States could not be sure whether they would be entitled to the investment rate of U.S. taxation on their U.S. investment income or whether their foreign source income would also become subject to U.S. tax.

RECOMMENDATIONS

1. As to estate taxation of nonresident aliens, it is recommended that the initial suggestion of the Fowler task force with regard to the elimination of U.S. estate taxes on intangible personal property of nonresident aliens decedents be followed.

2. It is recommended that interest paid on deposits in foreign branches of U.S. banks be treated as foreign source income. This treatment is proposed in H.R. 11297 for foreign currency deposits; it should be extended to include dollar deposits.

3. As to income taxation of interest paid on bank deposits in the United States to nonresident aliens and foreign corporations not doing business in the United States, it is recommended that the treatment proposed in H.R. 11297 for the period 1966 through 1970, which in effect continues the present exemption which has existed since 1921, be continued after 1970.

4. As to the taxation of nonresident aliens and foreign corporations engaged in trade or business in the United States, it is recommended that such persons be taxed only on their U.S. source income. It is further recommended that the term "effectively connected" be defined so as to eliminate the problems discussed above.

5. Because of the importance of the above-described changes in the U.S. tax law proposed by H.R. 11297, it is urged that hearings be held by the Ways and Means Committee to consider the full implications of the proposals.

NEW YORK CHAMBER OF COMMERCE,
New York, N.Y., January 11, 1966.

To the Members of the Committee on Finance and Currency and Committee on Taxation, New York Chamber of Commerce, New York, N.Y.

GENTLEMEN: Mr. Norris Johnson, chairman of the Committee on Finance and Currency has drafted the attached memorandum on H.R. 11297, pointing out certain discriminations against American banks which are included in this bill. If enacted into law, these inequities would not only penalize American banks, but they would have the direct opposite effect for which H.R. 11297 is intended to produce—to alleviate the balance-of-payments deficit.

Mr. Johnson believes that a joint statement on H.R. 11297 by the Committee on Finance and Currency and the Committee on Taxation should be drafted to make known the chamber's views on this bill. Mr. Weston Vernon, Jr., chairman of the Committee on Taxation concurs with this suggestion.

A statement will be drafted in the near future for submission to members of both committees. In the meantime, if any committee member wishes to express any opinion on the memorandum or the bill itself, please contact me.

Sincerely yours,

FRANK A. BRADY, JR.,
Research Department.

H.R. 11297—Proposed Foreign Investors Tax Act

The balance-of-payments problem requires corrective measures along many fronts. One of these is to make it more attractive for foreigners to hold U.S. dollar investments in the United States. Toward this end, beginning in 1962, the Congress authorized exemption of foreign official time deposits from interest rate ceilings under the Federal Reserve's Regulation Q, the Treasury increased Treasury bill offerings to help lift their yields, and the Federal Reserve successively raised discount rates. On April 27, 1964, the Fowler Committee submitted to President Johnson a report, originally requested by President Kennedy, on the subject of "Promoting Increased Foreign Investment in U.S. Corporate Securities and Increased Foreign Financing for U.S. Corporations Operating Abroad." President Johnson's balance-of-payments program dated February 10, 1965, recommended new legislation to increase the incentives for foreigners to invest in U.S. corporate securities.

The proposed Foreign Investors Tax Act, H.R. 11297, has the purpose of encouraging foreign investment in the United States by removing tax barriers to such investment. A number of provisions in the bill will contribute to that end. Some other provisions, losing sight of the essential purpose, would make investments in the United States less attractive and hence damage the balance of payments.

The bill would make subject to U.S. income taxation interest paid to nonresident aliens [1] and make immediately subject to U.S. estate taxation bank deposits of nonresident aliens when held in dollars with American banks and their branches. These discriminations against American banks, and against dollar deposits, are certainly uncalled for. There are many competitive foreign institutions eager to take on the business of American banks and to shift funds into foreign currencies or Eurodollars as required to relieve themselves and their customers of U.S. tax liabilities. Foreign jurisdictions, like the United Kingdom and Canada, which carry on an international banking business, as a matter of course exempt from income taxation interest on deposits paid to nonresident aliens.

It needs to be understood that the United States has financed past balance-of-payments deficits by encouraging foreigners to place and keep dollar deposits with U.S. banks. Apart from deposits of tax exempt foreign official institutions, the amount involved is approximately $10 billion. If private holders of dollars in New York moved these dollars into foreign currencies, there would be an increase in foreign official holdings of dollars convertible into gold. The result might be the same if the dollars were moved into Eurodollar deposits with foreign banks. All the other benefits of the legislation could be quickly undone.

It is inappropriate to the role of the dollar as the world's key currency to remove existing exemptions from taxation of bank deposits of nonresident aliens. It is incredible that such a step should be seriously considered at the present moment with effects of under-

[1] The latest available form of the bill would make this provision apply after Dec. 31, 1970, with exemptions in favor of foreign central banks of issue and otherwise as may be provided in tax treaties.

mining laborious other efforts to bring our international payments into balance and stop the gold drain. We need to attract foreign money, not drive it out.

NORRIS O. JOHNSON.

DECEMBER 29, 1965.

NEW YORK CLEARING HOUSE,
New York, N.Y., January 19, 1966.

Hon. WILBUR D. MILLS,
Chairman, Ways and Means Committee,
House of Representatives, Washington, D.C.

DEAR MR. MILLS: The member banks of the New York Clearing House Association are disturbed by certain provisions of the bill now before your committee described as the "Foreign Investors Tax Act of 1965" (H.R. 11297).

I enclose a memorandum setting forth our views on this bill which I hope will be helpful to you. Copies of the memorandum are also being sent to the members of your committee and to its staff.

If the Clearing House can be of further assistance in this matter please call on us.

Sincerely yours,

GEORGE CHAMPION, *President.*

MEMORANDUM RELATING TO H.R. 11297

This memorandum is submitted by the New York Clearing House Association to emphasize the conflict between the Government's overriding policy of encouraging foreign investments in the United States and the proposals of H.R. 11297 to end the exemption of nonresident foreign individuals and foreign corporations not engaged in business within the United States from U.S. income and estate taxes on their bank deposits.

The exemption from U.S. income tax for U.S. bank deposit interest received from nonresident foreign individuals or foreign corporations not engaged in business within the United States was first inserted into the Internal Revenue Code in 1921. The proponents of the exemption were at that time deeply concerned that U.S. banks were being prevented by reason of the U.S. tax on bank interest paid to such persons from effectively competing with foreign banks for the business of these foreign individuals and corporations. Since similar taxes were not imposed by most countries whose banks were competing with ours, Congress determined that the welfare of the United States would best be served by eliminating our income tax on this category of interest. These considerations are even more urgent today. The threat to our balance of payments if such interest becomes taxable now or in the near future points up the importance of maintaining the present exemption.

As introduced to the Ways and Means Committee of the House of Representatives, H.R. 11297 would subject interest paid to nonresident foreign individuals and foreign corporations not engaged in business in the United States (hereafter collectively referred to as "nonresident foreigners") to a flat 30-percent tax, beginning on January 1, 1971. Assuming U.S. bank interest rates of between 4 and 5 percent, the tax would reduce the net yield on invested principal to nonresident foreigners by between 1 and 1½ percent per annum.

In proposing to repeal the estate tax exemption for U.S. bank deposits held by nonresident foreign individuals, the bill, if enacted in its present form, would provide an added reason for such persons withdrawing their U.S. bank accounts.

It is clear that a decline of between 1 and 1½ percent in the yield on U.S. bank deposits would make most foreign investors look elsewhere for higher interest rates. The interest equalization tax itself, our prime weapon in the struggle to right our balance of payments, is based on the principle that a 1-percent change in yield has a critical effect on willingness to invest. In the words of President Kennedy, the tax is designed to "increase by approximately 1 percent, the interest cost to foreigners of obtaining capital in this country, and thus help equalize interest rate patterns for longer term financing in the United States and abroad."

Transfers of capital presently deposited in U.S. banks by nonresident foreigners would be welcomed by many foreign countries where bank interest rates are at least as high as in the United States and where bank interest paid to nonresident foreign depositors is tax exempt. Among the Western European countries offering these benefits are the Netherlands, West Germany, Sweden, Denmark, Finland, and Greece.

While there is no formal exemption from United Kingdom income tax on interest derived by nonresidents from money deposited in United Kingdom banks, United Kingdom law does not provide for withholding income tax on such interest at source, and the Chancellor of the Exchequer stated on March 9, 1965, that "it is not the general practice of the Inland Revenue to raise assessments on such interests."

If past experience is a fair guide, it can be reasonably expected that passage of H.R. 11297 in its present form will result in the transfer to banks in other countries of a large percentage of the deposits of nonresident foreigners in U.S. banks.

Any changes in the Internal Revenue Code which might lead to this result would be destructive of the stated purpose of H.R. 11297 "to encourage foreign investment in the United States—thereby beneficially affecting the U.S. balance of payments—by removing tax barriers to such investments." These changes would frustrate the recommendation of the Task Force on Promoting Increased Foreign Investment that foreign deposits be attracted to U.S. banks by raising interest rates paid to foreigners. The changes would be inconsistent with President Johnson's personal appeal to leading bankers and businessmen at the White House on February 18, 1965, to repatriate all liquid funds not urgently needed abroad. They would also be inconsistent with the directives to private business, both banking and nonbanking, contained in the voluntary 1966 guidelines addressed by the Board of Governors of the Federal Reserve System to financial institutions, and with the letter of Secretary of Commerce Connor to major industrial enterprises asking that they retain the maximum possible amount of liquid funds in this country. Finally, the proposed changes would run counter to the purpose of the interest equalization tax, which is to restrain capital outflow from the United States to those very countries whose banks would probably benefit most from a transfer of bank deposits of nonresident foreigners out of the United States.

Having expressed our concern on the adverse points in H.R. 11297, we would like to express agreement with the change in source rules which would classify interest paid by foreign branches of American banks on foreign currency deposits as foreign source income. We would urge that this same treatment be granted to interest paid on dollar deposits in foreign branches of American banks.

In view of the above, we urge the elimination from H.R. 11297 of the proposed amendments to sections 861 and 2104 of the Internal Revenue Code which would subject to income and estate taxation bank deposits and interest thereon owned by nonresident foreign individuals and foreign corporations not engaged in business within the United States.

The New York Clearing House Association: The Bank of New York; the Chase Manhattan Bank (National Association); First National City Bank; Chemical Bank New York Trust Co.; Morgan Guaranty Trust Co. of New York; Manufacturers Hanover Trust Co.; Irving Trust Co.; Bankers Trust Co.; Marine Midland Grace Trust Co. of New York; United States Trust Co. of New York.

JANUARY 19, 1966.

NEW YORK COUNTY LAWYERS ASSOCIATION,
COMMITTEE ON TAXATION,
New York, N.Y., January 18, 1966.

Hon. WILBUR D. MILLS,
Chairman, Ways and Means Committee, House of Representatives, Washington, D.C.

DEAR MR. MILLS: This committee has made a study of the Foreign Investors Tax Act of 1965 (H.R. 11297) and wishes to file a memorandum objecting to certain provisions thereof. However, due to the extreme pressure of work over the yearend, we have been unable to complete the memorandum.

I should appreciate it if you would advise when hearings on the bill will be held and the deadline for filing objections thereto.

Very truly yours,

CARTER T. LOUTHAN, *Chairman.*

New York County Lawyers Association Committee of Taxation

Report on H.R. 11297, The Foreign Investors Tax Act of 1965

Arthur M. Arnold
Richard A. Challed
James A. Cuddihy
Lawrence X. Cusack
Aaron M. Diamond
Edward A. Fogel
Maurice C. Greenbaum
Alex M. Hamburg
Malcolm Johnson
Wallace S. Jones
Donald H. Kallman
Mason G. Kassel
Jay O. Kramer, Secretary
Marvin Lyons
Ambrose V. McCall, Jr.
Ira J. Palestin
Ernest Rubenstein
J. Wesley Seward
Jack Turret
Marvin W. Weinstein
Carter T. Louthan, *Chairman*

A. GENERAL COMMENTS

1. Bank accounts and bonds

Since the Revenue Act of 1921, the interest on bank deposits has been exempt from income tax and such deposits have been excluded from the gross estate for estate tax purposes when received by, or owned by, nonresident aliens not engaged in business in the United States. Such provisions were adopted for the purpose of encouraging nonresident aliens to open and maintain back deposits in the country.

Section 2(a) of the bill amends the present law to expand the coverage of the present income tax exemption with respect to interest on bank deposits, but then provides for the repeal of the exemption as to interest paid or credited after December 31, 1970. The bill also provides that interest on a deposit made by a nonresident alien with the foreign branch of a U.S. bank will be exempt only if it is payable in a foreign currency and is not effectively connected with a business carried on in the United States. Section 8 of the bill provides that after the date of enactment of the act, a dollar deposit made by a nonresident alien with the foreign branch of a U.S. bank will be subject to estate tax.

Under present law bonds issued by U.S. obligors are subject to estate tax when owned by nonresident aliens, only if the bond is physically located in the United States. Section 8 of the bill, which is effective immediately, will subject bonds to the estate tax irrespective of their location, if issued by U.S. obligors.

A major purpose of the bill is stated to be the encouragement of foreign investment in the United States so as to help the U.S. balance of payments. The 5-year delay in the repeal of the income tax exemption with respect to bank interest presumably was designed to encourage such deposits during the 5-year period. However, aliens are quite sensitive to estate tax liabilities and the possibility of incurring estate tax on such deposits or on bonds of U.S. obligors undoubtedly will induce many nonresident alien individuals to close out their bank deposits and to dispose of bonds of U.S. obligors immediately, despite the temporary continuance of the income tax exemption.

The failure to grant an estate tax exemption as to dollar deposits with foreign branches of U.S. banks also will have an immediate adverse effect on the U.S. balance of payments as well as on the profits of the U.S. banks having such foreign branches. Very few nonresident alien individuals will leave dollar deposits with the foreign branch of a U.S. bank and risk incurring estate tax liability, when they can achieve equal security by opening a dollar account with a Swiss bank which is prohibited by law from disclosing their interest in the Swiss bank's deposit with its U.S. correspondent.

Disallowing the interest exemption as to dollar deposits with foreign branches of U.S. banks will put the branches at a competitive disadvantage with foreign banks. Many U.S. corporations have formed financing subsidiaries to borrow U.S. dollars abroad. Loans are then made by the financing subsidiary to a subsidiary which wishes to expand its operations. If such a subsidiary has more funds than it currently needs, it will normally deposit them with the foreign branch of a U.S. corporation. However, the tax disadvantage of doing so, undoubtedly will cause such subsidiaries to temporarily invest their excess dollars in some other manner. This inability of the foreign branch of a U.S. bank to compete for such funds inevitably will have an adverse effect upon the bank's ability to earn profits as well as upon the U.S. balance of payments.

In view of the foregoing, we recommend that the proposed disallowance of these exemptions and the change in the situs rule as to bonds not be enacted. On the other hand, we approve of the proposed expansion of the income tax exemption but recommend that the limitation as to foreign currency in the case of foreign branches and the repeal of the exemptions after December 31, 1970, not be enacted.

2. Income effectively connected with the conduct of a trade or business

Under the present statute, a nonresident alien not engaged in trade or business in the United States is subject to a flat rate of tax withheld at the source from fixed or determinable annual or periodical income from sources within the United States. If such income exceeds $21,200 a return must be filed and a tax paid at graduated rates.

If a nonresident alien is engaged in trade or business in the United States, the present statute requires a return to be filed to report the income from sources within the United States and that the tax be computed thereon in the same manner as is applicable to residents.

The determination of whether income is from sources within or without the United States is made under statutory rules which have been in effect for so long that their meaning is pretty well fixed.

Under the bill, the flat withholding tax will be applicable only if the income is not effectively connected with the conduct of a trade or business in the United States. The requirement that tax be paid at graduated rates if the income exceeds $21,200 is dropped. If, on the other hand, the income is effectively connected with the conduct of a trade or business in the United States, it will be subject to tax at graduated rates, even though under the normal source rules it would be deemed to be from sources without the United States.

Thus the taxability of income and the method of taxing it is made to depend upon whether the income is or is not effectively connected with the conduct of a trade or business in the United States rather than upon whether the taxpayer is engaged in trade or business in the United States and the usual source rules.

The term "effectively connected" had its genesis in the OECD model treaty and has been used in the new United States-German Income Tax Convention. The concept involves a term which is novel and has no clear meaning in ordinary speech, nor does a resort to the dictionary produce a sensible meaning for the term. The statute does not attempt to define the term, but section 2(c) sets out three factors which are to be taken into account in determining whether gains, profits and income, or loss are to be treated as effectively connected with the conduct of a trade or business. However, only the factors set forth in subdivisions (1) and (3) are similar to the factors mentioned in the Memorandum of Understanding with Respect to the Protocol to the United States-German Income Tax Convention. The factor mentioned in subdivision (2) of the statute but not in the memorandum of understanding is whether the gains, profits or income, or loss are accounted for through such trade or business.

The new factor added by the statute is an extremely loose concept and seems likely to cause considerable adminstrative difficulty. If the rule is applied literally, it is apt to be a trap for the unwary and a facile means of evasion for the sophisticated. If the rule is to be applied on the basis of what the Service decides should have been accounted for through such trade or business, great uncertainty will be injected into the statute. Accounting is not an exact science and competent accountants can disagree violently as to what is good accounting practice in a particular situation.

Except where uniform accounting rules are imposed upon taxpayers by regulatory authorities, as for example in the case of insurance companies, accounting rules should be omitted as a factor.

The first factor—whether assets are used in the conduct of the trade or business—also may unduly favor taxpayers who are well advised and penalize those who are not. If the cash requirements of a U.S. branch of a foreign corporation fluctuate from time to time, it may become desirable to make a temporary investment of the excess cash.

If an investment in U.S. bonds appeared desirable, the cash would be remitted to the home office which would then invest it. Under those circumstances, the interest would not appear to be effectively connected with the U.S. business and thus would incur the withholding tax of 30 percent, or the rate might be reduced to 15 percent or entirely eliminated by a treaty.

If an investment in U.S. stocks appeared desirable, the cash would be left under the control of the branch, which would make and hold the investment. Under those circumstances, the dividends would seem to be effectively connected with the branch's business. The dividends received deduction allowable under those circumstances would reduce the effective rate of tax to 7.2 percent.

In view of the genesis of the term "effectively connected" there is another factor which deserves consideration. Austria, Belgium, Canada, Denmark, England, France, the Federal Republic of Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and Turkey are members of OECD. Presumably one or more or all of those countries may utilize the term in treaties with other countries. If the concept is written into the statute, it would seem desirable for the committee reports to make it clear that the administrative or judicial interpretation placed upon the term by the officials or courts of these other countries should be ignored in determining the meaning of our statute.

It seems questionable whether the uncertainties inherent in the "effectively connected" concept should be injected into the law at this time when every effort should be made to encourage foreign investment in the United States.

B. TECHNICAL PROBLEMS

1. Elections to treat real property income as effectively connected with U.S. business

Under sections 3(d) and 4(d) nonresident alien individuals and foreign corporations are given an election to treat investment real property as effectively connected with the conduct of a trade or business in the United States so as to pay tax upon the net income rather than upon the gross. This provision is similar to provisions in many income-tax conventions except that the election is irrevocable (unless the Secretary consents to its revocation) whereas the treaties permit the election to be made annually.

It would appear desirable to grant the election annually or to at least put some limit upon the applicability of the election. Otherwise the election may continue to be binding for years after the disposition of property which originally occasioned the election with unanticipated tax results flowing from an isolated sale of real property or the receipt of natural resource royalties.

This situation also will make it necessary for those aliens who have the right to make annual elections under treaties to be careful to specify that their election is being made under the treaty rather than under the statute.

2. Withholding

Under section 3(g) of the bill, withholding is required with respect to fixed or determinable annual or periodical income (as well as certain items which do not fit that description) from sources within the United States, as determined under normal source rules, unless the income is effectively connected with the conduct of a trade or business in the United States.

In view of the uncertainty which inevitably will arise as to whether certain items of income are effectively connected with the conduct of a business in the United States, withholding agents will act at their peril. If they reach the wrong answer as to whether the income is effectively connected with the U.S. business, they will be liable to the United States for failing to withhold or to the alien payee for withholding when they should not have. Withholding agents should be required to withhold only where the applicable rules are easily determinable.

Similar considerations apply to the requirement that the tax be withheld (unless the gain is effectively connected with the business) from gains realized in "collapsible" transactions and upon the redemption of bonds issued at a discount. Foreigners will not be encouraged to invest here if they are required to consider provisions as complex as these nor should withholding agents (who receive no compensation for withholding) be required to act at their peril in determining such a complex question.

3. Insurance companies

Section 4 of the bill applies the same general rules to foreign insurance companies as are applied to other foreign corporations. The income effectively connected with the insurance business carried on in the United States is taxed in the same manner as that of domestic insurance companies, while income not so connected is subject to the flat tax withheld at the source.

The difference in the effective rate of tax upon dividends (7.2 or 30 percent) under the two rules, makes the determination of whether dividend income is effectievly connected with the conduct of the U.S. business, of extreme importance to foreign insurers doing business here. In the event the "effectively connected" concept is adopted, it would seem that the investment income should be deemed to be effectively connected with the conduct of the U.S. insurance business. If there is any doubt as to this the statute should be clarified.

Section 4(j)(2) amends section 953(b)(3)(F) of the code with respect to insurance companies, by substituting 832(c)(5) for 832(b)(5). This change has nothing to do with the changes being made by the bill, but merely corrects an error in the present law. The erroneous reference 832(b)(5) had the effect of disallowing insurance losses rather than capital losses as clearly intended. The correction therefore should be made retroactively, rather than to limit it to taxable years beginning after December 31, 1965, as provided by section 4(k).

NEW YORK STATE BAR ASSOCIATION,
TAX SECTION,
February 10, 1966.

LEO H. IRWIN, Esq.,
Chief Counsel, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR SIR: Enclosed for the use of the chairman and members of the House Ways and Means Committee and their staff are 20 copies of a report on H.R. 11297 which was prepared by the Subcommittee on Income Tax Problems of Nonresident Aliens, which is a subcommittee of the Personal Income Tax Committee of the tax section of the New York State Bar Association. We will forward 10 more copies of this report to you as soon as they are available.

The enclosed report has been approved by the executive committee of the tax section of the New York State Bar Association, but it has not been submitted to the bar association as a whole or to the executive committee of the bar association. Accordingly, the views expressed should be regarded as the views of the persons preparing and reviewing the report rather than the official position of the New York State Bar Association.

We hope that the comments contained in this report will prove useful.

Very truly yours,

THOMAS C. PLOWDEN-WARDLAW,
Chairman.

NEW YORK STATE BAR ASSOCIATION, TAX SECTION

Martin A. Roeder, chairman, Charles J. Block, Martin D. Ginsburg, Saul Duff Kronovet, James C. Plowden-Wardlaw, and David R. Tillinghast, January 15, 1966

REPORT OF SUBCOMMITTEE ON INCOME TAX PROBLEMS OF NONRESIDENT ALIENS WITH RESPECT TO H.R. 11297

Bill section 2(a)(1)(A): IRC section 861(a)(1)(A) and (c)(2)—Interest

The purpose of this amendment is to extend the present exemption of interest on deposits with persons carrying on the banking business to amounts earned on accounts maintained with Federal or State chartered savings and loan associations (such interest is often labeled a "dividend" by the savings institution). This will end a great deal of current confusion. Nonresident aliens are often surprised when a withholding tax is deducted from interest earned on such accounts due to the fact that the alien is technically a "shareholder" instead of a creditor.

The proposed amendment is limited to cases where the "amounts" paid or credited are "deductible" by the association under section 591, i.e., where such amounts are withdrawable on demand, subject to customary notice. This limitation will cause uncertainty since existing section 861(a)(1)(A) and proposed section 861(c)(1) (interest on deposits with persons carrying on the banking business) contain no such requirement. Further, reference to section 591 requires consideration of section 265, which disallows interest paid to purchase or carry tax-exempt bonds. Since savings and loan associations often purchase municipal bonds, it is possible that, due to application of section 265, a portion of the interest paid to depositors or account holders will not be deductible under section 591.

This bill purports to encourage foreign investment in the United States by removing tax barriers to such investment. In line with this intent, it is suggested that reference to section 591 be deleted; or in the alternative, the addition to the phrase "without regard to section 265" should be inserted after "section 591."

It is further suggested that this amendment be expanded so as to cover certificates of deposit, a form of investment which, in recent years, has expanded enormously. While it is believed that present section 861(a)(1)(A) (and proposed section 861(c)(1)) are applicable to certificates of deposit, there is some uncertainty on the point in banking circles, with the result that many banks are reluctant to sell CD's to nonresident aliens. CD's are technically deposits (reserve requirements apply) and a clarification of the law is in order.

Proposed section 861(c)(3) would further extend the exemption to "amounts held by an insurance company under an agreement to pay interest thereon." While this amendment is probably intended to cover funds left with life insurance companies by beneficiaries, annuitants, and owners of matured policies, the proposed text literally would include interest paid by any insurance company (life or casualty) to its noteholders, bondholders, or other creditors. A clarification of this proposed subsection is necessary.

Bill section 2(b) (1): IRC section 861(a) (2) (B)—Dividends

This section states that dividends received from a foreign corporation will be deemed to be income from U.S. sources unless "less than 80 percent of the gross income of such foreign corporation for the 3-year period ending with the close of its taxable year * * * was effectively connected with the conduct of a trade or business within the United States * * *." If 80 percent or more of such gross income was effectively connected with the conduct of a trade or business within the United States, income is deemed to be from U.S. sources in the ratio that the gross income which is effectively connected with the conduct of a U.S. trade or business bears to total "gross income from all sources."

It is not clear whether the "gross income" of the foreign corporation for purposes of applying the 80-percent test is intended to be its gross income from U.S. sources only or its gross income from all sources. In this regard, reference should be made to proposed section 872(a) and section 82(b), both of which define gross income as income from U.S. sources or income which is effectively connected with the conduct of a trade or business within the United States whatever the source. Reference should also be made to the formula portion of section 861(a) (2) (B) which expressly specifies "gross income *from all sources*" [italics supplied] when foreign as well as domestic income is to be considered. To avoid ambiguity, the point should be clarified. It is submitted that the term "gross income" as used in the opening phrase of this section should be followed by the phrase "from all sources."

The policy considerations behind the proposed change are unclear. The summary of the new bill furnished by the Committee on Ways and Means refers to this provision as pertaining to the "second dividend" tax. Although such a characterization might be correct under present law (where the foreign corporation receiving dividends from sources within the United States may be subject to withholding tax upon the distribution thereof as a second such dividend), it seems inapposite in the new bill where the withholding tax on the foreign corporation applies only when 80 percent or more of the gross income of such foreign corporation is effectively connected with the conduct of a trade or business in the United States. Manifestly, such type of income would include little or no dividend income—and it is unlikely that any withholding tax would ever be a "*second* dividend" tax. Since the policy of the new bill is to very sharply narrow the number of cases in which the withholding tax in the case of a foreign corporation is to apply, it is submitted that the concept should be excised from the statute completely (as is done, in effect, by several treaties) and dividends from foreign corporations should never be considered as being income from sources within the United States.[1]

Bill section 2(d) (1): IRC section 864(b) (1)—Personal Services

This section excludes from the definition of trade or business within the United States the performance of personal services by a nonresident alien under certain circumstances. The section, however, leaves open the question of whether a nonresident alien working for a foreign entity in the United States, although himself not deemed to be en-

[1] David Tillinghast, Esq., a member of the subcommittee, expresses no views on this point.

gaged in trade or business under section 864(b)(1), will, nevertheless, cause his foreign employer to be deemed to be engaged in trade or business in the United States. It is recommended that a decision be made as to whether the foreign employer in such cases should be deemed to be engaged in trade or business here and that the decision be spelled out in the statute.

The proposed section also raises the question of why a nonresident alien working for a domestic entity with an office or place of business abroad is treated differently from a nonresident alien working for a domestic entity that has no office or place of business abroad. The determinative facts would appear to be that a nonresident alien is employed by a U.S. entity, that the normal working location of the nonresident alien is abroad, and that he is required to be present in the United States only for limited periods of time. It would appear that the 90-day-$3,000 rule is a sufficient test by itself.

Bill section 2(d)(1): IRC section 864(b)(2)—Trading in securities

This proposed section provides that trading in stocks or securities for the nonresident alien's own account will generally not be deemed a "trade or business in the United States." However, a foreign investment company is denied this benefit "if its principal office is in the United States." Since many incorporation statutes provide that the "principal office" of a corporation must be in the country of incorporation, it should be made clear that the phrase "principal office" as used in the proposed bill is used to describe the actual activities of the office rather than the statutory office. Perhaps the phrase should be expanded to read, "if its main, principal or most important office is in the United States."

Bill sections 2(d)(1), 3(a)(1), 3(b)(1), 4(b): IRC sections 864(c), 871(b), 872(a), 882(b)—Effectively connected income—Gross income

The proposed bill does away with the "force of attraction" principle (whereby the foreigner's engaging in business in the United States causes all of his U.S. source income to be taxed at normal rates) which characterizes the present law. Under the new concept, the foreigner (individual or corporate) will be subject to progressive taxation on net income only with respect to his "taxable income effectively connected with the conduct of his trade or business." Thus, the same foreigner may have various types of income—income from passive investment and income effectively connected to a U.S. trade or business—each subject to a different method of U.S. taxation.

This subcommittee feels that the new approach is sound in principle. Since the bill provides no definition of "effectively connected" income, other than to lay down guidelines (sec. 864(c)) as to the factors to be considered in reaching a determination, it is to be expected that administrative difficulties will ensue and that results, at least for a while, will be haphazard. No ready solution is available.

The subcommittee, however, is of the opinion that the inclusion of "effectively connected" income from sources outside the United States is not justified. Source rules have, over the years, become well known to the Internal Revenue Service and the public, and the increased revenue from the attempt to enlarge the tax base by inclusion of "effectively connected" income from foreign sources would not, it is felt, justify the proposed radical departure from the older rules. Moreover, the proposed extension does not fall within one of the stated objectives of the bill to encourage foreign investment in the United States.

Bill section 3(a)(1): IRC section 871(a)(1)—Periodic income

This section imposes a flat 30-percent tax on periodic income of nonresident aliens which is not effectively connected with the conduct of a trade or business within the United States. The familiar enumeration of interest, dividends, rents, etc. is retained. Also retained is the taxation of gains under section 1235 (gains from the sale or exchange of patents). In addition, the 30-percent tax will now apply to gain on the sale, exchange, or liquidation of stock of a collapsible corporation (sec. 341) and to "interest" earned on bonds or other original discount debt instruments issued after a specified date (sec. 1232).

The provisions of new proposed section 871(a)(2) (relating to capital gains) will not apply to section 1235 income. It therefore appears that capital losses cannot offset section 1235 gains. In effect, gains realized by nonresident alien inventors would be treated as ordinary investment income, subject to a 30-percent tax, without offset. The law thus discriminates against foreign inventors, as it denies them the capital gain treatment accorded resident inventors, with the anomalous result that a relief statute (sec. 1235) actually results in a detriment to a foreign inventor who might, but for section 1235, get capital gain treatment under sections 1221 *et seq.* Consideration should be given to allowing foreign inventors capital gain treatment (often resulting in no tax) to the extent that they would qualify therefor without the benefit of section 1235.

Bill section 3(a)(1): IRC section 871(a)(2)—Capital gains

This section imposes a capital gains tax upon nonresident alien individuals who are present in the United States for 183 days or more during the taxable year at the flat rate of 30 percent. No capital gains tax is imposed upon foreign corporations except to the extent that such gains are effectively connected with a U.S. trade or business. Sections 881, 882.

A question exists as to the proper tax treatment of sales made on the installment basis. If a nonresident alien is present for the required period during the year of sale but is not present in the United States for the required period during the year of receipt of an installment, it would appear that he is not subject to tax under section 871(a)(2) in respect of such installment.

It is to be noted that no provision is made in respect of the capital gains of foreign estates or trusts. Since in many cases it is difficult to conceive of a "presence" in the United States of a foreign estate or trust, except inventories, it would appear that such estates or trusts may often not be subject to U.S. tax on its capital gains.

Although the subcommittee prefers not to comment on policy questions, the members of the subcommittee believe that the proposed capital gains tax on nonresident aliens would not only be difficult to enforce but is in the nature of a "nuisance" tax rather than a revenue measure. Little if any revenue can be derived from this source since the tax can easily be avoided by (a) selling the asset abroad, (b) forming foreign corporations for U.S. investments or, apparently, (c) setting up foreign trusts for such investments. Under these circumstances, the proposed capital gains tax would be applicable in most cases only to unsophisticated nonresident aliens as distinguished from aliens who have the advice of tax counsel. For the foregoing reasons, despite a possible justification of the capital gains tax on theoretical grounds, it is recommended that the capital gains tax on nonresident aliens be completely eliminated except with respect to capital gains effectively connected with the conduct of a trade or business in the United States.

Bill section 3(a)(1): IRC section 871(d)—Real estate income

Proposed section 871(d) grants to the non-resident-alien individual an election to have certain U.S.-source income from specified interests in real property, including gain from the sale of realty, treated as "income which is effectively connected with the conduct of a trade or business within the United States," and thus as income taxed in the manner provided in proposed section 871(b) which renders such income taxable as provided in section 1 or section 1201(b) of the code.

(*a*) Proposed section 871(d) does not make reference to loss on the sale or exchange of realty, suggesting that only gain is to be taken into account. The provision should be clarified. Compare proposed section 873.

(*b*) As a matter of basic policy, quaere why the election should not be given with respect to all U.S. source income rather than just realty income.

The comparable provision of prior H.R. 5916 was a proposed section 871(f). In this subcommittee's report on that section there appeared criticisms in addition to the above comments. The new provision of H.R. 11297 eliminates those additional criticisms.

Bill section 3(b)(3): IRC section 872(b)(4)—Savings bonds income

Proposed section 872(b)(4) would exclude from U.S. source gross income of certain non-resident-alien individuals "income" from series E and series H bonds. The text of the provision correctly refers to "income" on such bonds but the heading of proposed section 872(b)(4) incorrectly refers to "interest" on bonds. As the reference to interest is inappropriate in the case of series E bonds, it should be changed in the heading to read "income".

Bill section 3(e)(1): IRC section 877—Expatriation

The proposed amendment would, unless none of the principal purposes of the expatriation was to avoid U.S. income, estate or gift tax, subject expatriates to regular income taxes, for a period of 5 years after expatriation, on their U.S.-source income, defined to include gains on all sales of property located in the United States and on sales of stock and securities of U.S. corporations, plus their "effectively connected" income even if from foreign sources.

It does not seem appropriate that a principal purpose to avoid estate tax or gift tax should have the prescribed income tax effects. It is suggested that references to subtitle B be eliminated from the opening sentence. Cf. Section 8(f) of the bill from which it is recommended that references to subtitle A be deleted.

Section 10 of the bill provides that no amendment made thereby shall supersede an existing treaty. Accordingly, an expatriate to a treaty country would presumably still enjoy the benefits thereof (e.g., limitation of tax on dividends to 15 percent, on interest to 5 percent, etc.). Although it is true that, to some extent, our treaties provide these benefits only to countries in which the domestic rates are themselves high, thus discouraging expatriation to them, this subcommittee is of the view that once the policy to tax expatriates is adopted (as to which this subcommittee expresses no view), section 10 of the bill should be amended to provide that the new proposed section 877 override existing treaties (Cf. sec. 31 of the 1962 R.A.).

The proposed new treatment of capital gains realized by an expatriate applies even to gains on assets acquired after expatriation. This appears an undue extension of the proposal, and it is suggested that the Secretary or his delegate be empowered to alleviate the effect of the proposed amendment in cases where the property on which the gains are realized was afteracquired. Per contra, the new proposal probably does not reach gains on installment sales made during the 5-year period, but includible in income thereafter. Consideration should be given as to whether this situation should be covered.

The proposed section provides that if an expatriate's "taxes on his probable income" are shown to be substantially reduced, the burden of proving that the expatriation did not have as one of its principal purposes the avoidance of U.S. taxes shall be on the taxpayer. It is not clear whether the "taxes on his probable income" means only the U.S. taxes thereon or the entire tax burden thereon including the taxes of the country of his expatriation. This should be clarified. Cf. section 963.

It seems clear that nothing in the proposed amendment changes the status of the expatriate as a nonresident alien for definitional purposes under the Internal Revenue Code. For example, the expatriate should not be deemed to be a "United States citizen or resident" under section 552(a)(2). It is recommended, however, that this be made absolutely clear by appropriate committee report or otherwise in the course of enactment.

Bill section 4(b)(1): IRC section 882(c)(2)—Necessity to file return

This section permits deductions allowed "in this subtitle" to a foreign corporation only if it files a true and accurate return of its total income from U.S. sources. It is noted that the section, as under present law, applies to foreign corporations that are personal holding companies and, because of the broad language, "in this subtitle," operates to disallow dividends-paid deductions unless a return is filed.

It is recommended that the section be revised so as to allow specifically the dividends-paid deduction for personal holding company tax purposes whether or not a return has been filed and that the change be made retroactive to 1954. In practice, foreign corporations that are owned, essentially, by nonresident aliens and which believe that their liability has been fully met by withholding at the source, may fail to file U.S. income tax returns. In a number of instances, such corporations may make dividend distributions to nonresident alien shareholders. If subsequent investigation or audit discloses that the corporations in question were personal holding companies, especially since only U.S. source income is considered, the corporations may be placed in an impossible position. It is not believed that any useful purpose is served by continuing the present rule, and it is suggested that past inequities caused by this rule be corrected by making the suggested change retroactive.

Bill section 4(b) (1) : IRC section 882(e)—Corporate return by agent

Proposed section 882(e) does not differ from current law, but a clarification in language may nevertheless be desirable. The provision states that if a foreign corporation has an agent but not an office or place of business in the United States, its tax return "*shall* be made by the agents [emphasis supplied]. It would appear preferable to add at the end of the sentence, immediately following the quoted phrase, "unless such return is made by the foreign corporation directly."

Bill section 4(k)—Effective dates

The amendments made by section 4 of the bill are applicable, generally, in respect of taxable years beginning after December 31, 1965. As previously recommended in respect of proposed section 882(c) (2) of the code, if the dividends paid deduction is allowed for personal holding company tax purposes, whether or not a return is filed by a foreign corporation, such change should be made retroactive to 1954. Consideration should also be given as to whether the proposed revision of section 542(c) (sec. 4(f) of the bill), exempting a foreign corporation from personal holding company status if all its stock during the last half of a taxable year is owned by nonresident-alien individuals, should not also be made retroactive.

Dated January 15, 1966.

Statement of G. Keith Funston, President, New York Stock Exchange

SUMMARY

The New York Stock Exchange enthusiastically supports the basic goals of the proposed legislation—to increase incentives for foreigners to invest in the United States. We regard the bill as a vital and necessary step toward inducing foreigners to invest here. It accepts a contention long held by the exchange regarding the need to unfetter international securities transactions from overly rigid constraints. It moves significantly toward the recommendations of the Presidential Task Force on Promoting Foreign Investment and Increased Foreign Financing headed by now Secretary of the Treasury Henry H. Fowler. One of the stated objectives of that report was, "To help establish conditions under which restraining influences on capital flows between the industrially advanced nations * * * can be removed, diminished, or allowed to expire." If U.S. taxation of foreign investors and other inhibiting factors are alleviated and our private selling efforts are reinforced, given the favorable prospects for the U.S. economy, it is not unreasonable to expect the savings accumulated in other industrial countries flowing here for investment to be increased—to the benefit of our balance of payments.

Despite this general endorsement, we have serious reservations about a number of provisions in the bill which conflict with its overall objective of stimulating foreign investment in the United States and aiding our balance of payments. The exchange, therefore, suggests the following deletions, amendments and additions to H.R. 11297:

1. Delete the provisions which make bank deposits of foreigners subject to the estate tax, and which provide that whether or not they are engaged in business here foreigners would be taxed on interest they receive on U.S. bank deposits after 1970.

2. Eliminate the estate tax on nonresident aliens completely, instead of providing only a rate reduction.

3. If estates continue to be taxed, retain the situs rule on bonds. In addition, exclude customers' cash balances with brokers awaiting investment from property considered taxable for estate tax purposes.

4. Repeal or reduce the withholding tax levied on interest and dividents paid to foreigners. As a minimum step, press for mutual reductions with other countries in the percentage withheld.

5. Eliminate or ease taxes and other restrictions imposed on foreign pension trusts and similar institutional investors.

6. The exchange specifically endorses the language in section 2 of the bill referring to "Trading in Securities and Commodities," as revised from the original administration proposals.

H.R. 11297, the Foreign Investors Tax Act of 1966, accepts the philosophy and recommendations of the Presidential Task Force on the Balance of Payments (the Fowler Committee), of which the exchange president was a member. It codifies steps long advocated by representatives of the exchange community regarding international financing. The task force recommendations were originally embodied in H.R. 5916, submitted by the administration to the Congress for consideration in 1965. In its statement on H.R. 5916, the exchange noted that, "Adoption of this legislation would do much to stimulate the long-term flow of foreign capital to the United States, in part by removing archaic restrictions on the flows. The securities industry has long advocated removal of such restrictions. The exchange applauds the fact that the proposed legislation will enhance the freedom of movement in the international flow of capital funds."

The legislation, appropriately cast, should aid our balance-of-pay ments problem. As the late President Kennedy observed in his last balance-of-payments message to the Congress, "Securities of U.S. private firms could be and should be one of our bestselling exports." This proposed legislation, by removing some bothersome and complex restraints, should make American securities a good deal more salable to foreign investors.

Although supporting the basic philosophy of the bill, we wish to bring to the attention of the Congress our serious reservations about specific provisions of the current version of this proposal. We have great concern that unless these provisions are modified, the legislation might well produce unfavorable rather than favorable reactions in the financial markets of the world and on our balance of payments.

The changes from the original (H.R. 5916) version of the bill which appear in H.R. 11297 tend to undercut a good deal of the legislation's basic purpose of stimulating foreign investment in the United States. Specifically, the provisions which make bank deposits of foreigners subject to the estate tax, and which provide that foreigners, whether or not they are engaged in business here, would, after 1970, be taxed on the interest they receive on deposits in U.S. banks and savings and loan associations, will surely lead to a sizable outflow of foreign capital.

At the end of October 1965, total banking liabilities to foreigners amounted to close to $30 billion. The Treasury estimates that perhaps $5 billion of these deposits would be potentially subject to either the estate tax or to annual taxation of interest income. It seems reasonable to assume that part, perhaps the major part, of this $5 billion would be withdrawn over a period of time from the U.S. banks in response to these changes.

Consequently, the exchange strongly urges that the proposed legislation be revised to omit those sections which change the treatment of bank deposits of foreigners. An impediment to the free flow of international capital funds will thereby be avoided and our balance-of-payments position will not be damaged.

Apart from these sections, the legislation as written can be materially strengthened in several other ways, as discussed below, and moved closed to its objective, as outlined by the Fowler Committee, of providing greater stimulus to foreign investment. In addition, the effectiveness of a program to encourage foreign investment in U.S. securities may be enhanced by adopting several measures not included in the tax bill.

Consequently, the exchange suggests the following adjustments and additions:

1. *Elimination of estate tax on nonresident aliens.*—Section 8 of the bill proposes that estate tax rates be reduced to between 25 and 40 percent of present levels, thereby taxing nonresident aliens at about the same rates as U.S. citizens who claim a marital deduction. We recommend the complete elimination of estate taxes on nonresident aliens. This would provide a much greater stimulus to foreign investment in the United States than any rate reduction, and therefore be a much greater help to our balance of payments. First, many foreigners are discouraged from investing here by the existing requirement that they file estate tax returns. This deterrent would be removed if the tax were eliminated. Second, since even the proposed tax rates are higher than those now levied in many countries, investment by residents of those countries would still be discouraged.

The rates now in the bill are higher than the ones proposed by the administration, and stop far short of the Fowler committee recommendation to "eliminate U.S. estate taxes on all intangible personal property of nonresident alien decedents." Though the proposed rates would be below those levied on resident estates in the United Kingdom, Canada, and Italy, they would be higher than those imposed in Switzerland, Germany, France, and the Netherlands. Thus, the legislation favors the residents of some countries while discriminating against those of others.

Elimination of the estate tax on nonresident aliens would result in a very small revenue loss. The tax has produced revenues of between $3 and $5 million annually in recent years, and would probably yield only about $1 million under the proposed legislation. An additional revenue loss of $1 million would seem to be a very small price to pay for the removal of a major deterrent to foreign investment. The benefits of the change to our balance of payments would in itself be ample compensation for the revenue loss.

2. *Elimination of situs rule on bonds.*—If the rate schedule proposed in the legislation is adopted, the exchange strongly urges that the situs rule regarding bonds not be changed. A change in the situs rule would have a decidedly adverse effect on the balance of payments.

Under President Johnson's voluntary program to reduce capital outflows, American companies are being urged to finance their overseas investments through local borrowing. Over $300 million worth of bonds were floated in Europe in 1965 in response to the President's appeal. The proposed change in the situs rule could jeopardize this program by placing an unnecessary block on the efforts of American firms to finance their overseas expansion in foreign capital markets. Foreign investors would clearly become reluctant to purchase bonds of American companies if this exposed them to U.S. estate taxation. Moreover, it would be extremely difficult administratively to enforce this change in the law. Since bonds are generally issued in bearer form, we known of no practical way of identifying their owners for tax collection purposes.

3. *Exemption of free credit balances from estate taxation.*—The exchange also suggests, if foreigners remain subject to the estate tax, that section 2105 of the Internal Revenue Code be amended so that all funds awaiting investment not be considered property within the United States for estate tax purposes. This should apply not only to deposits in banks and savings and loan associations, but also to free credit balances with brokers.

4. *Definition of "engaged in trade or business."*—The exchange wishes specifically to endorse the language referring to "trading in securities or commodities" under the revision of section 864 of the Internal Revenue Code. The language pertaining to trading by dealers in securities and commodities under the original administration proposals was vague, and the risk of misinterpretation was great. The revised language in H.R. 11297 clarifies the intent of the legislation.

5. *Repeal of withholding on interest and dividend payments.*—Consideration should be given to unilateral repeal of the withholding tax on interest and dividends paid to foreigners. A reduction in the percentage withheld would be a minimum step in this direction. The withholding tax clearly deters investment by foreigners, and its repeal or reduction would appreciably stimulate foreign purchases of U.S. securities.

If the potential revenue loss makes unilateral action undesirable (the United States obtained perhaps $100 million from the withholding tax in 1965), the United States should press for mutual reductions in the withholding tax with as many foreign countries as possible. Since transactions in outstanding securities have generally produced an inflow of funds to the United States, mutual reductions in the withholding rate could be expected to stimulate more foreign purchases of U.S. securities than U.S. purchases of foreign securities—even considering the temporary adverse effect of the interest equalization tax.

6. *Easing taxes on foreign pension trusts.*—Taxes and other restrictions imposed on foreign pension trusts and similar investors should be eased. Domestic pension funds enjoy a tax exemption on their investment income. Foreign pension funds cannot obtain this exemption without going through the difficult procedure of obtaining approval from numerous agencies of the U.S. Government. As a result, these investors are discouraged from investing here, especially if they are exempt from taxes in their country of domicile.

Pension funds in some foreign countries have grown dramatically in recent years. For example, the Joint Economic Committee study of European capital markets indicates that pension funds in Great Britain have been one of the fastest growing institutions in that country's financial structure, and had investments of $10 billion at the end of 1962.[1] Further growth is fully expected. It seems reasonable to assume, therefore, that by according foreign pension funds a tax treatment similar to that enjoyed by domestic funds, a considerable capital flow into the United States might be stimulated. Further, one can be confident that the Treasury in its regulations can provide the safeguards necessary to prevent any abuse of this legislation.

Consequently, taxes on the income of foreign pension funds and similar institutional investors should be eliminated by law; alternatively, these investors should be able to obtain tax exemption more readily. As a minimum step, the United States should work toward the mutual elimination of taxes on these types of investors.

The exchange, in endorsing the spirit of this bill, believes that adoption of these changes, amendments, and additions would greatly enhance its effectiveness and better achieve its objective of stimulating foreign investment and aiding our balance-of-payments position.

THE PROPRIETARY ASSOCIATION,
Washington, D.C., February 21, 1966.

Re H.R. 11297.

Hon. WILBUR D. MILLS,
Chairman, House Ways and Means Committee,
U.S. House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: The Proprietary Association respectfully recommends that public hearings be held on H.R. 11297.

Although we recognize that public hearings were held last year on H.R. 5916, the forerunner of H.R. 11297, substantive changes have been made since that time which go beyond the original proposed legislation. Because of these changes we believe that hearings on the present bill (H.R. 11297) would be in the public interest.

Respectfully submitted.

HOWARD A. PRENTICE,
Executive Vice President and Treasurer.

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[1] U.S. Congress, Joint Economic Committee, "A Description and Analysis of Certain European Capital Markets," 1964, p. 238.

SAUL S. SILVERMAN,
LAW OFFICES,
New York, N.Y., February 18, 1966.

Re H.R. 11297.

Hon. WILBUR D. MILLS,
Chairman, House Ways and Means Committee,
House of Representatives, Washington, D.C.

DEAR SIR: We have recently reviewed the report on H.R. 11297, published by the House Ways and Means Committee.

The report indicates that executive, administrative, technical, purchasing, or other activities in the United States on behalf of or for the benefit of a foreign corporation could result in the foreign corporation being subjected to U.S. taxation on its income from sources outside of the United States if H.R. 11297 were enacted in its present form.

It is our opinion that this new tax burden on foreign corporations is arbitrary and discriminatory and we hereby make known our most strong opposition and objection to this bill. That is, if a foreign corporation conducts its entire operating activity in a foreign country, activity on behalf of the foreign corporation in the United States of the type outlined above should not subject it to U.S. taxation on the foreign source income. This is clearly a tenuous connection to tax liability.

Further, thus far no standards as to what constitutes activity on behalf of a foreign corporation have been promulgated. If these standards are as all encompassing as indicated by the report, then U.S.-owned foreign corporations with foreign source income will acquire a double tax nexus. This is in contrast with the stated purpose of the bill, which is directed at the taxation of foreign corporations. In order to harmonize with this purpose, the bill should provide that it be applicable only to foreign corporations the stock of which is majority owned by foreigners.

We respectfully request that you consider this viewpoint and that you advise us as to the disposition of our request for public hearings on H.R. 11297.

Very truly yours,

SAUL S. SILVERMAN,
By HENRY R. SILVERMAN.

SOCONY MOBIL OIL CO., INC.,
New York, N.Y., January 28, 1966.

Re Foreign Investors Tax Act.

Hon. WILBUR D. MILLS,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: The purpose of this letter is to express concern over certain provisions of the Foreign Investors Tax Act, H.R. 11297, and to suggest the desirability of public hearings on this bill.

Concern over the precise terms of this bill arises from two causes, one more narrowly related to the specific purpose of the legislation and the other of potentially much wider consequence.

In the first category, I refer to the inclusion in the bill of the following features:

1. Estate tax at rates up to 25 percent (as contrasted with 15 percent in H.R. 5916 and zero as recommended by the Fowler task force) on intangible personal property of nonresident-alien decedents.
2. Inclusion of U.S. bank deposits owned by nonresident aliens not engaged in trade or commerce in the United States in the taxable estate of aliens dying after enactment of the bill.
3. Inclusion in the taxable estate of nonresident aliens of bonds issued by domestic corporations or governmental units in this country although held by the nonresident alien outside the United States.
4. The indicated intention after December 31, 1970, to tax interest received by nonresident-alien individuals or foreign corporations on U.S. bank deposits.

All of these changes have some tendency to discourage foreign investment in U.S. securities and none, I believe, will produce any significant revenue. For this reason, as one who was a member of the Fowler task force and as an officer of a corporation having a tremendous interest in the U.S. balance of payments, I regret and respectfully counsel against these provisions.

Even more significant are the provisions of H.R. 11297 which would include in the United States taxable income of nonresident aliens and foreign corporations engaged in trade or business in the United States their worldwide income provided that it is "effectively connected" with the U.S. trade or business. This departure from source rules in the taxation of foreigners is a major departure from long-existing tax jurisprudence in this country.

This statutory language and the proposed statement of criteria for determining "effective connection" are so broadly drawn as to result in great uncertainty: wide areas would have to be filled in part by Treasury regulations and decisions and in part by the results of litigation. We understand from conferences with members of the Treasury Department that this vagueness has been recognized but it is their view that the report of your committee will solve the problem through a detailed discussion of the applicability of the new provisions. It would seem preferable that the relevant provisions of H.R. 11297 be strengthened and clarified to reduce the need for relying upon lengthy explanations in your committee's report.

We understand that certain relatively narrow tax situations motivate the Treasury in this context; specifically, we have been advised that the new provisions are aimed at nonresident alien individuals and foreign corporations controlled abroad and are not aimed at the controlled foreign subsidiaries of U.S. corporations. Your committee took the leading role in formulating provisions in the Revenue Act of 1962 which deal with controlled foreign corporations as now defined in section 957(a). It seems that it would be unnecessary and unwise to subject such corporations both to the subpart F income provisions and to the uncertainty of the "effectively controlled" provisions. Clarification could be most effectively accomplished by amending the proposed wording of section 882 as now continued in H.R. 11297. One way in which this might be done would be to insert a provision such as that contained in the attachment to this letter. If your committee would be uncertain as to the advisability of this change, then we would strongly request an opportunity for public hearings.

We will be happy to discuss this matter with you at your convenience, or to supply you with any additional information which you may desire.

We are enclosing sufficient copies of this letter so that you may distribute them to members of your committee should you so desire.

Very truly yours,

GEORGE F. JAMES,
Senior Vice President.

PROPOSED REVISION OF SECTION 882 AS CONTAINED IN THE FOREIGN INVESTORS TAX ACT

Section 882 as contained in section 4(b) of the Foreign Investors Tax Act, H.R. 11297, should be modified by inserting a provision along the following lines:

"(d) CONTROLLED FOREIGN CORPORATIONS.—In the case of a controlled foreign corporation as defined in section 957(a), gross income shall include only gross income from sources within the United States. Deductions allowable under subsection (c) of this section shall be allowed only to the extent connected with income from sources within the United States."

The succeeding subsections would be renumbered (e) and (f) accordingly.

JANUARY 25, 1966.

UPJOHN INTERNATIONAL, INC.,
Kalamazoo, Mich., February 11, 1966.

WILBUR D. MILLS,
Chairman, House Ways and Means Committee,
House Office Building, Washington, D.C.:

Our company respectfully requests public hearings on H.R. 11297, designed to encourage foreign investments in the United States. Substantial changes are incorporated in historical rules for determining income of foreign corporations doing business in the United States. Hearings are specifically needed to clarify language "effectively connected."

R. M. BOUDEMAN,
President.

SECTION 12

PRESS RELEASE OF THE COMMITTEE ON WAYS AND MEANS DATED FEBRUARY 24, 1966, ANNOUNCING ONE-DAY PUBLIC HEARING ON NEW FEATURES OF "FOREIGN INVESTORS TAX ACT OF 1965" (H.R. 11297) WHICH WILL BE INTRODUCED AS A "CLEAN BILL" ON MONDAY, FEBRUARY 28, 1966

(See Section 14 of this document, page 527)

SECTION 13

H.R. 13103 AS INTRODUCED IN THE HOUSE OF REPRESENTATIVES

(See Section 14 of this document, page 530)

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SECTION 14

HEARINGS BEFORE THE COMMITTEE ON WAYS AND MEANS ON H.R. 13103

FOREIGN INVESTORS TAX ACT OF 1966

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

EIGHTY-NINTH CONGRESS

SECOND SESSION

ON

H.R. 13103

TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO PROVIDE EQUITABLE TAX TREATMENT FOR FOREIGN INVESTMENT IN THE UNITED STATES

MARCH 7, 1966

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1966

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FOREIGN INVESTORS TAX ACT OF 1966

MONDAY, MARCH 7, 1966

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, D.C.

The committee met at 10 a.m., pursuant to notice, in the committee room, Longworth House Office Building, Hon. Wilbur D. Mills (chairman of the committee) presiding.

The CHAIRMAN. The committee will please be in order.

The purpose of the hearing today is to receive comments from the interested public on H.R. 13103, the Foreign Investors Tax Act of 1966.

This bill supersedes H.R. 11297 and H.R. 5916. It will be recalled that the committee conducted public hearings on the original bill, H.R. 5916, and also received written comments on H.R. 11297.

Without objection a copy of the press release announcing these hearings, along with a copy of the bill, H.R. 13103, will be made a part of the record.

(The documents referred to follow:)

FEBRUARY 24, 1966.

CHAIRMAN WILBUR D. MILLS, DEMOCRAT, OF ARKANSAS, COMMITTEE ON WAYS AND MEANS, ANNOUNCES 1-DAY PUBLIC HEARING ON NEW FEATURES OF FOREIGN INVESTORS TAX ACT OF 1965 (H.R. 11297) WHICH WILL BE INTRODUCED AS A "CLEAN BILL" ON MONDAY, FEBRUARY 28, 1966

SUBJECT AND DATE OF HEARING

Chairman Wilbur D. Mills, Democrat, of Arkansas, Committee on Ways and Means, today announced the decision of the Committee on Ways and Means to conduct a public hearing on Monday, March 7, 1966, on the new features of a revised version of H.R. 11297, the Foreign Investor's Tax Act of 1965, which is being drafted and which will be introduced by the chairman in the form of a new bill on Monday, February 28, 1966. The printed text of such new bill will be available on Tuesday morning, March 1, 1966.

Chairman Mills emphasized that the hearing would cover only the new features of the new bill which he will introduce. These are generally described below. It is mandatory that persons with a similar interest coordinate and consolidate their testimony and designate one spokesman, as described more fully below.

CUTOFF DATE FOR REQUESTS

The cutoff date for requests to be heard is 12 o'clock noon, Friday, March 4, 1966. Requests to be heard should be submitted to the chief counsel of the Committee on Ways and Means, Mr. Leo H. Irwin, room 1102, Longworth House Office Building, Washington, D.C., not later than noon Friday, March 4, 1966.

BACKGROUND

It will be recalled that on March 8, 1965, Chairman Mills, at the request of the administration, introduced H.R. 5916, a bill to remove tax barriers to foreign investment in the United States, to make certain technical amendments, and for other purposes, which was developed by the administration on the basis of the recommendations of the so-called Fowler Task Force. The Committee on Ways and Means conducted public hearings on this legislation on June 30 and July 1, 1965, and received testimony not only from Secretary of the Treasury Fowler, but also from interested public witnesses who asked to be heard, as well as representatives of the task force which developed the original recommendations. In addition, numerous written statements were received by the committee and made a part of the published hearings on H.R. 5916. The printed hearings were made available to the general public.

It will be further recalled that in July 1965, the Committee on Ways and Means met for several days in executive session to consider the provisions of H.R. 5916 in the light of the testimony which had been received from the Treasury Department and from the interested public witnesses as well as the written statements on the bill. At the conclusion of the executive consideration of this subject, Chairman Mills, at the direction of the Committee on Ways and Means, introduced a new bill on this subject, H.R. 11297, on September 28, 1965, which succeeded H.R. 5916 and is known as the Foreign Investors Tax Act of 1965. Immediately following the introduction of H.R. 11297, a printed explanation of its provisions was made available to the public. In this printed explanation an invitation was issued to the general public to express their views on the bill, as follows: "The bill was introduced by Chairman Wilbur D. Mills at the instruction of the Committee on Ways and Means in order to make it available for the information of the general public. Comments received will be reviewed by the committee before the bill is reported to the House in the next session of the Congress." As a result of that announcement, numerous written comments were received during the fall of 1965 and in the early weeks of the current year. These comments were all consolidated and made available to the members of the Committee on Ways and Means for their consideration.

The bill which Chairman Mills plans to introduce on Monday, February 28, represents a further refinement of H.R. 11297, particularly with respect to the concept of "effectively connected" income. It is only on the further refinements of this proposed legislation that the Committe on Ways and Means will receive testimony on Monday, March 7, 1966.

Chairman Mills emphasized that the committee is interested only in receiving comments on the further refinements of this legislation and is not interested in receiving a duplication of comments which have already been presented to the committee in the public hearings on June 30 and July 1, 1965, and in the written comments which have been made available to the committee during the fall of 1965 and in the early weeks of the current year.

DIFFERENCES BETWEEN H.R. 11297 AND THE BILL TO BE INTRODUCED

The most significant respects in which the provisions of the revised bill differs from those contained in H.R. 11297 are:

The provision relating to interest paid on deposits with the foreign branch of a U.S. bank has been amended so that such interest will not be treated as income from sources within the United States regardless of whether the deposit is in dollars or in a foreign currency. In addition, all such deposits held by nonresident aliens will be exempt from estate tax. The effective date of the provision subjecting to tax interest paid to foreigners on deposits with U.S. banks has been postponed to January 1, 1972.

The section in H.R. 11297 dealing with "effectively connected" income has also been revised. While the new bill continues the segregation of U.S. investment income from U.S. business income which was provided for in H.R. 11297, it substantially limits the foreign source income which may be treated as being effectively connected to a U.S. business. Under the provisions of the new bill, foreign source income will only be treated as effectively connected with a U.S. business if the foreigner conducts such business through an office or other fixed place of business within the United States to which such income is attributable and such income is of certain specified types. These types of income are (1) royalties for the use of intangible property, which are derived in the active conduct of a licensing business, (2) dividend, interest, and gains from the sale of stock, securities or notes derived in the conduct of a banking, financing, or similar business or, in some cases, an investment company, and (3) sales income attributable to the foreigner's U.S. office, but, except in the case of goods sold for use in the United States, only if the foreigner does not have an office outside the United States which participates materially in making the sale.

Moreover, under no circumstances will foreign source income which is subpart F income or which consists of dividends, interest or royalties paid by a subsidiary or other affiliated foreign company be treated as effectively connected with a U.S. business.

COORDINATION OF TESTIMONY

The chairman further stated that, due to the heavy schedule of the committee, the hearing must be completed on March 7, 1966, and to that end it is mandatory that all interested individuals and organizations with a similar interest coordinate their testimony and designate one spokesman in order to conserve the time of the committee, prevent repetition, and assure that all aspects of the matter will be given appropriate attention within the time allocation.

The committee will be pleased to receive from any interested person a written statement for inclusion in the printed record of the hearing in lieu of a personal appearance. These statements will be given the same full consideration as though the statements had been presented in person. In such cases, where statements are submitted in lieu of a personal appearance, a minimum of three copies of the statement should be submitted by the close of business Monday, March 7, 1966.

CONTENTS OF REQUESTS TO BE HEARD

In order to eliminate repetitious testimony and to properly schedule witnesses and allocate time, it will be necessary for the requests to be heard to specify—

(1) The name, address, and capacity in which the witness will appear;

(2) The list of persons the witness represents or, in the case of an association or other organization, their total membership and where possible a membership list of the association or organization;

(3) The amount of time the witness desires in which to present his direct oral testimony;

(4) An indication of whether or not the witness is supporting or opposing the changes in the bill; and

(5) A summary of the comments and recommendations which the witness proposes to make.

WRITTEN STATEMENTS

In the case of those persons who are scheduled to appear and testify, it is requested that 60 copies of their written statements be submitted at least 24 hours in advance of their scheduled appearance. If it is desired an additional 60 copies may be submitted for distribution to the press and the interested public on the witness' date of appearance. Persons submitting written statements in lieu of a personal appearance may also, if they desire, submit an additional 60 copies of their statements for distribution to the committee members and the interested departmental and legislative staffs pending the printing of the public hearings, which will include such statements along the oral testimony of those persons who appear in person. An additional 60 copies may be submitted for the press and the interested public if it is desired.

FORMAT OF ALL WRITTEN STATEMENTS

To more usefully serve their purpose, all written statements should begin with a summary of comments and recommendations and the detailed statements which follow should contain subject headings conforming to the summary of comments and recommendations.

[H.R. 13103, 89th Cong., 1st sess. Introduced by Mr. Mills on February 28, 1966.]

A BILL To amend the Internal Revenue Code of 1954 to provide equitable tax treatment for foreign investment in the United States

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE, ETC.

(a) SHORT TITLE.—This Act may be cited as the "Foreign Investors Tax Act of 1966".

(b) TABLE OF CONTENTS.—

(c) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference is to a section or other provision of the Internal Revenue Code of 1954.

SEC. 2. SOURCE OF INCOME.

(a) INTEREST.—

(1) (A) Subparagraph (A) of section 861(a)(1) (relating to interest from sources within the United States) is amended to read as follows:

"(A) interest on amounts described in subsection (c) received by a nonresident alien individual or a foreign corporation, if such interest is not effectively connected with the conduct of a trade or business within the United States,".

(B) Section 861 is amended by adding at the end thereof the following new subsection:

"(c) INTEREST ON DEPOSITS, ETC.—For purposes of subsection (a)(1)(A), the amounts described in this subsection are—

"(1) deposits with persons carrying on the banking business,

"(2) deposits or withdrawable accounts with savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law, but only to the extent that amounts paid or credited on such deposits or accounts are deductible under section 591 in computing the taxable income of such institutions, and

"(3) amounts held by an insurance company under an agreement to pay interest thereon.

Effective with respect to amounts paid or credited after December 31, 1971, subsection (a)(1)(A) and this subsection shall cease to apply."

(2) Section 861(a)(1) is amended by striking out "and" at the end of subparagraph (B), by striking out the period at the end of subparagraph (C) and inserting in lieu thereof ", and", and by adding at the end thereof the following new subparagraph:

"(D) interest on deposits with a foreign branch of a domestic corporation, if such branch is engaged in the commercial banking business."

(3) (A) Section 895 (relating to income derived by a foreign central bank of issue from obligations of the United States) is amended—

(i) by striking out "shall not be included" and inserting in lieu thereof ", or from interest on deposits with persons carrying on the banking business, shall not be included";

(ii) by striking out "such obligations" and inserting in lieu thereof "such obligations or deposits";

(iii) by adding at the end thereof the following new sentence: "For purposes of the preceding sentence, the Bank for International Settlements shall be treated as a foreign central bank of issue with respect to interest on deposits with persons carrying on the banking business."; and

(iv) by striking out the heading and inserting in lieu thereof the following:

"SEC. 895. INCOME DERIVED BY A FOREIGN CENTRAL BANK OF ISSUE FROM OBLIGATIONS OF THE UNITED STATES OR FROM BANK DEPOSITS."

(B) The table of sections for subpart C of part II of subchapter N of chapter 1 is amended by striking out the item relating to section 895 and inserting in lieu thereof the following:

"Sec. 895. Income derived by a foreign central bank of issue from obligations of the United States or from bank deposits."

(b) DIVIDENDS.—

(1) Section 861(a)(2)(B) (relating to dividends from sources within the United States) is amended to read as follows:

(B) from a foreign corporation unless less than 80 percent of the gross income from all sources of such foreign corporation for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was effectively connected with the conduct of a trade or business within the United States; but only in an amount which bears the same ratio to such dividends as the gross income of the corporation for such period which is effectively connected with the conduct of a trade or business within the United States bears to its gross income from all sources; but dividends from a foreign corporation shall, for the purposes of subpart A of part III (relating to foreign tax credit), be treated as income from sources without the United States to the extent (and only to the extent) exceeding the amount which is 100/85ths of the amount of the deduction allowable under section 245 in respect of such dividends, or".

(2) Section 861(a)(2) is amended by adding after subparagraph (C) the following:

"For purposes of subparagraph (B), the gross income of the foreign corporation for any period before the first taxable year beginning after December 31, 1966, which is effectively connected with the conduct of a trade or business within the United States is an amount equal to the gross income for such period from sources within the United States."

(c) PERSONAL SERVICES.—Section 861(a)(3)(C)(ii) (relating to income from personal services) is amended to read as follows:

"(ii) an individual who is a citizen or resident of the United States, domestic partnership, or a domestic corporation, if such labor or services are performed for an office or place of business maintained in a foreign country or in a possession of the United States by such individual, partnership, or corporation."

(d) DEFINITIONS.—Section 864 (relating to definitions) is amended—

(1) by striking out "For purposes of this part," and inserting in lieu thereof

"(a) SALE, ETC.—For purposes of this part,"; and

(2) by adding at the end thereof the following new subsections:

"(b) TRADE OR BUSINESS WITHIN THE UNITED STATES.—For purposes of this part, part II, and chapter 3, the term 'trade or business within the United States' includes the performance of personal services within the United States at any time within the taxable year, but does not include—

"(1) PERFORMANCE OF PERSONAL SERVICES FOR FOREIGN EMPLOYER.—The performance of personal services—

"(A) for a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, or

"(B) for an office or place of business maintained in a foreign country or in a possession of the United States by an individual who is a citizen or resident of the United States or by a domestic partnership or a domestic corporation.

by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year and whose compensation for such services does not exceed in the aggregate $3,000.

"(2) TRADING IN SECURITIES OR COMMODITIES.—

"(A) STOCKS AND SECURITIES.—

"(i) Except in the case of a dealer in stocks or securities, trading in stocks or securities for the taxpayer's own account, whether by the taxpayer or his employees or through a resident broker, commission agent, custodian, or other agent, and whether or not any such agent has discretionary authority to make decisions in effecting the transactions. This clause shall not apply in the case of a corporation (other than a corporation which is, or but for section 542(c)(7) would be, a personal holding company) the principal business of which is trading in stocks or securities for its own account, if its principal office is in the United States.

"(ii) In the case of a person who is a dealer in stocks or securities, trading in stocks or securities for his own account through a resident broker, commission agent, custodian, or other independent agent.

"(B) COMMODITIES.—

"(i) Except in the case of a dealer in commodities, trading in commodities for the taxpayer's own account, whether by the taxpayer or his employees or through a resident broker, commission agent, custodian, or other agent, and whether or not any such agent has discretionary authority to make decisions in effecting the transactions.

"(ii) In the case of a person who is a dealer in commodities, trading in commodities for his own account through a resident broker, commission agent, custodian, or other independent agent.

"(iii) Clauses (i) and (ii) apply only if the commodities are of a kind customarily dealt in on an organized commodity exchange and if the transaction is of a kind customarily consummated at such place.

"(C) LIMITATION.—Subparagraphs (A)(ii) and (B)(ii) shall apply only if, at no time during the taxable year, the taxpayer has an office or place of business in the United States through which or by the direction of which the transactions in stocks or securities, or in commodities, as the case may be, are effected.

"(c) EFFECTIVELY CONNECTED INCOME, ETC.—

"(1) GENERAL RULE.—For purposes of this title—

"(A) In the case of a nonresident alien individual or a foreign corporation engaged in trade or business within the United States during the taxable year, the rules set forth in paragraphs (2), (3), and (4) shall apply in determining the income, gain, or loss which shall be treated as effectively connected with the conduct of a trade or business within the United States.

"(B) Except as provided in section 871(d) or section 882(d), in the case of a nonresident alien individual or a foreign corporation not engaged in trade or business within the United States during the taxable year, no income, gain, or loss shall be treated as effectively connected with the conduct of a trade or business within the United States.

"(2) PERIODICAL, ETC., INCOME FROM SOURCES WITHIN UNITED STATES—FACTORS.—In determining whether income from sources within the United States of the types described in section 871(a)(1) or section 881(a), or whether gain or loss from sources within the United States from the sale or exchange of capital assets, is effectively connected with the conduct of a trade or business within the United States, the factors taken into account shall include whether—

"(A) the income, gain, or loss is derived from assets used in or held for use in the conduct of such trade or business, or

"(B) the activities of such trade or business were a material factor in the realization of the income, gain, or loss.

In determining whether an asset is used in or held for use in the conduct of such trade or business or whether the activities of such trade or business were a material factor in realizing an item of income, gain, or loss, 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 applying this paragraph and paragraph (4), interest referred to in section 861(a)(1)(A) shall be considered income from sources within the United States.

"(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.

"(4) INCOME FROM SOURCES WITHOUT UNITED STATES.—

"(A) Except as provided in subparagraph (B), no income, gain, or loss from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States.

"(B) Income, gain, or loss from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States by a nonresident alien individual or a foreign corporation if such person has an office or other fixed place of business within the United States to which such income, gain, or loss is attributable and such income, gain, or loss—

"(i) consists of rents or royalties for the use of or for the privilege of using intangible property described in section 862(a)(4) (including any gain or loss realized on the sale of such property) derived in the active conduct of such trade or business;

"(ii) consists of dividends or interest, or gain or loss from the sale or exchange of stock or notes, bonds, or other evidences of indebtedness, and either is derived in the active conduct of a banking, financing, or similar buisness within the United States or is received by a corporation the principal business of which is trading in stock or securities for its own account; or

"(iii) is derived from the sale (without the United States) through such office or fixed place of business of personal property described in section 1221(1), except that this clause shall not apply if the property is sold for use, consumption, or disposition outside the United States and an office or other fixed place of business of the taxpayer outside the United States participated materially in such sale.

In the case of a sale described in clause (iii), the income which shall be treated as attributable to the office or other fixed place of business within the United States shall not exceed the income which would be derived from sources within the United States if the sale were made in the United States.

"(C) No income, gain, or loss from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States if it either—

"(i) consists of dividends, interest, or royalties paid by a foreign corporation in which the taxpayer owns (within the meaning of section 958(a)), or is considered as owning (by applying the ownership rules of section 958(b)), more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or

"(ii) is subpart F income within the meaning of section 952(a)."

(e) EFFECTIVE DATES.—

(1) The amendments made by subsections (a), (c), and (d) shall apply with respect to taxable years beginning after December 31, 1966.

(2) The amendments made by subsection (b) shall apply with respect to amounts received after December 31, 1966.

SEC. 3. NONRESIDENT ALIEN INDIVIDUALS.

(a) TAX ON NONRESIDENT ALIEN INDIVIDUALS.—

(1) Section 871 (relating to tax on nonresident alien individuals) is amended to read as follows:

"SEC. 871. TAX ON NONRESIDENT ALIEN INDIVIDUALS.

"(a) INCOME NOT CONNECTED WITH UNITED STATES BUSINESS—30 PERCENT TAX.—

"(1) INCOME OTHER THAN CAPITAL GAINS.—There is hereby imposed for each taxable year a tax of 30 percent of the amount received from sources within the United States by a nonresident alien individual as—

"(A) interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income,

(B) gains described in section 402(a)(2), 403(a)(3), or 631 (b) or (c), and gains on transfers described in section 1235, and

"(C) amounts which under section 341, or under section 1232 (in the case of bonds or other evidences of indebtedness issued after September 28, 1965), are treated as gains from the sale or exchange of property which is not a capital asset,

but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States.

"(2) CAPITAL GAINS OF ALIENS PRESENT IN THE UNITED STATES 183 DAYS OR MORE.—In the case of a nonresident alien individual present in the United States for a period or periods aggregating 183 days or more during the taxable year, there is hereby imposed for such year a tax of 30 percent of the amount by which his gains, derived from sources within the United States, from the sale or exchange at any time during such year of capital assets exceed his losses, allocable to sources within the United States, from the sale or exchange at any time during such year of capital assets. For purposes of this paragraph, gains and losses shall be taken into account only if, and to the extent that, they would be recognized and taken into account if such gains and losses were effectively connected with the conduct of a trade or business within the United States, except that such gains and losses shall be determined without regard to section 1202 (relating to deduction for capital gains) and such losses shall be determined without the benefits of the capital loss carryover provided in section 1212. Any gain or loss which is taken into account in determining the tax under paragraph (1) or subsection (b) shall not be taken into account in determining the tax under this paragraph. For purposes of the 183-day requirement of this paragraph, a nonresident alien individual not engaged in trade or business within the United States who has not established a taxable year for any prior period shall be treated as having a taxable year which is the calendar year.

"(b) INCOME CONNECTED WITH UNITED STATES BUSINESS—GRADUATED RATE OF TAX.—

"(1) IMPOSITION OF TAX.—A nonresident alien individual engaged in trade or business within the United States during the taxable year shall be taxable as provided in section 1 or 1201(b) on his taxable income which is effectively connected with the conduct of a trade or business within the United States.

"(2) DETERMINATION OF TAXABLE INCOME.—In determining taxable income for purposes of paragraph (1), gross income includes only gross income which is effectively connected with the conduct of a trade or business within the United States.

"(c) PARTICIPANTS IN CERTAIN EXCHANGE OR TRAINING PROGRAMS.—For purposes of this section, a nonresident alien individual who (without regard to this subsection) is not engaged in trade or business within the United States and who is temporarily present in the United States as a nonimmigrant under subparagraph (F) or (J) of section 101(a)(15) of the Immigration and Nationality Act, as amended (8 U.S.C. 1101(a)(15) (F) or (J)), shall be treated as a nonresident alien individual engaged in trade or business within the United States, and any income described in section 1441(b) (1) or (2) which is received by such individual shall, to the extent derived from sources within the United States, be treated as effectively connected with the conduct of a trade or business within the United States.

"(d) ELECTION TO TREAT REAL PROPERTY INCOME AS INCOME CONNECTED WITH UNITED STATES BUSINESS.—

"(1) IN GENERAL.—A nonresident alien individual who during the taxable year derives any income—

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"(A) from real property located in the United States, or from any interest in such real property, including (i) gains from the sale or exchange of real property or an interest therein, (ii) rents or royalties from mines, wells, or other natural deposits, and (iii) gains described in section 631 (b) or (c), and

"(B) which, but for this subsection, would not be treated as income which is effectively connected with the conduct of a trade or business within the United States,

may elect for such taxable year to treat all such income as income which is effectively connected with the conduct of a trade or business within the United States. In such case, such income shall be taxable as provided in subsection (b)(1) whether or not such individual is engaged in trade or business within the United States during the taxable year. An election under this paragraph for any taxable year shall remain in effect for all subsequent taxable years, except that it may be revoked with the consent of the Secretary or his delegate with respect to any taxable year.

"(2) ELECTION AFTER REVOCATION.—If an election has been made under paragraph (1) and such election has been revoked, a new election may not be made under such paragraph for any taxable year before the 5th taxable year which begins after the first taxable year for which such revocation is effective, unless the Secretary or his delegate consents to such new election.

"(3) FORM AND TIME OF ELECTION AND REVOCATION.—An election under paragraph (1), and any revocation of such an election, may be made only in such manner and at such time as the Secretary or his delegate may by regulations prescribe.

"(e) CROSS REFERENCES.—

"(1) For tax treatment of certain amounts distributed by the United States to nonresident alien individuals, see section 402(a)(4).

"(2) For taxation of nonresident alien individuals who are expatriate United States citizens, see section 877.

"(3) For doubling of tax on citizens of certain foreign countries, see section 891.

"(4) For reinstatement of pre-1967 income tax provisions in the case of residents of certain foreign countries, see section 896.

"(5) For withholding of tax at source on nonresident alien individuals, see section 1441.

"(6) For the requirement of making a declaration of estimated tax by certain nonresident alien individuals, see section 6015(i).

"(7) For taxation of gains realized upon certain transfers to domestic corporations, see section 1250(d)(3)."

(2) Section 1 (relating to tax on individuals) is amended by redesignating subsection (d) as subsection (e), and by inserting after subsection (c) the following new subsection:

"(d) NONRESIDENT ALIENS.—In the case of a non-resident alien individual the tax imposed by subsection (a) shall apply only as provided by section 871 or 877."

(b) GROSS INCOME.—

(1) Subsection (a) of section 872 (relating to gross income of nonresident alien individuals) is amended to read as follows:

"(a) GENERAL RULE.—In the case of a nonresident alien individual, gross income includes only—

"(1) 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 within the United States, and

"(2) gross income which is effectively connected with the conduct of a trade or business within the United States."

(2) Subparagraph (B) of section 872(b)(3) (relating to compensation of participants in certain exchange or training programs) is amended by striking out "by a domestic corporation" and inserting in lieu thereof "by a domestic corporation, a domestic partnership, or an individual who is a citizen or resident of the United States".

(3) Subsection (b) of section 872 (relating to exclusions from gross income) is amended by adding at the end thereof the following new paragraph:

"(4) BOND INTEREST OF RESIDENTS OF THE RYUKYU ISLANDS OR THE TRUST TERRITORY OF THE PACIFIC ISLANDS.—Income derived by a nonresident alien individual from a series E or series H United States savings bond, if such individual acquired such bond while a resident of the Ryukyu Islands or the Trust Territory of the Pacific Islands."

(c) DEDUCTIONS.—

(1) Section 873 (relating to deductions allowed to nonresident alien individuals) is amended to read as follows:

"SEC. 873. DEDUCTIONS.

"(a) GENERAL RULE.—In the case of a nonresident alien individual, the deductions shall be allowed only for purposes of section 871(b) and (except as provided by subsection (b)) only if and to the extent that they are connected with income which is effectively connected with the conduct of a trade or business within the United States; and the proper apportionment and allocation of the deductions for this purpose shall be determined as provided in regulations prescribed by the Secretary or his delegate.

"(b) EXCEPTIONS.—The following deductions shall be allowed whether or not they are connected with income which is effectively connected with the conduct of a trade or business within the United States:

"(1) LOSSES.—The deduction, for losses of property not connected with the trade or business if arising from certain casualties or theft, allowed by section 165(c)(3), but only if the loss is of property located within the the United States.

"(2) CHARITABLE CONTRIBUTIONS.—The deduction for charitable contributions and gifts allowed by section 170.

"(3) PERSONAL EXEMPTION.—The deduction for personal exemptions allowed by section 151, except that in the case of a nonresident alien individual who is not a resident of a contiguous country only one exemption shall be allowed under section 151.

"(c) CROSS REFERENCES.—

"(1) For disallowance of standard deduction, see section 142(b)(1).

"(2) For rule that certain foreign taxes are not to be taken into account in determining deduction or credit, see section 906(b)(1)."

(2) Section 154(3) (relating to cross references in respect of deductions for personal exemptions) is amended to read as follows:

"(3) For exemptions of nonresident aliens, see section 873(b)(3)."

(d) ALLOWANCE OF DEDUCTIONS AND CREDITS.—Subsection (a) of section 874 (relating to filing of returns) is amended to read as follows:

"(a) RETURN PREREQUISITE TO ALLOWANCE.—A nonresident alien individual shall receive the benefit of the deductions and credits allowed to him in this subtitle only by filing or causing to be filed with the Secretary or his delegate a true and accurate return, in the manner prescribed in subtitle F (sec. 6001 and following, relating to procedure and administration), including therein all the information which the Secretary or his delegate may deem necessary for the calculation of such deductions and credits. This subsection shall not be construed to deny the credits provided by sections 31 and 32 for tax withheld at source or the credit provided by section 39 for certain uses of gasoline and lubricating oil."

(e) EXPATRIATION TO AVOID TAX.—

(1) Subpart A of part II of subchapter N of chapter 1 (relating to nonresident alien individuals) is amended by redesignating section 877 as section 878, and by inserting after section 876 the following new section:

"SEC. 877. EXPATRIATION TO AVOID TAX.

"(a) IN GENERAL.—Every nonresident alien individual who at any time after March 8, 1965, and within the 5-year period immediately preceding the close of the taxable year lost United States citizenship, unless such loss did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle B, shall be taxable for such taxable year in the manner provided in subsection (b) if the tax imposed pursuant to such subsection exceeds the tax which, without regard to this section, is imposed pursuant to section 871.

"(b) ALTERNATIVE TAX.—A nonresident alien individual described in subsection (a) shall be taxable for the taxable year as provided in section 1 or section 1201(b), except that—

"(1) the gross income shall include only the gross income described in section 872(a) (as modified by subsection (c) of this section), and

"(2) the deductions shall be allowed if and to the extent that they are connected with the gross income included under this section, except that the capital loss carryover provided by section 1212(b) shall not be allowed; and the proper allocation and apportionment of the deductions for this purpose shall be determined as provided under regulations prescribed by the Secretary or his delegate.

For purposes of paragraph (2), the deduction allowed by section 873(b) shall be allowed; and the deduction (for losses not connected with the trade or business if incurred in transactions entered into for profit) allowed by section 165(c)(2) shall be allowed, but only if the profit, if such transaction had resulted in a profit, would be included in gross income under this section.

"(c) SPECIAL RULES OF SOURCE.—For purposes of subsection (b), the following items of gross income shall be treated as income from sources within the United States:

"(1) SALE OF PROPERTY.—Gains on the sale or exchange of property (other than stock or debt obligations) located in the United States.

"(2) STOCK OR DEBT OBLIGATIONS.—Gains on the sale or exchange of stock issued by a domestic corporation or debt obligations of United States persons or of the United States, a State or political subdivision thereof, or the District of Columbia.

"(d) EXCEPTION FOR LOSS OF CITIZENSHIP FOR CERTAIN CAUSES.—Subsection (a) shall not apply to a nonresident alien individual whose loss of United States citizenship resulted from the application of section 301(b), 350, or 355 of the Immigration and Nationality Act, as amended (8 U.S.C. 1401(b), 1482, or 1487).

"(e) BURDEN OF PROOF.—If the Secretary or his delegate establishes that it is reasonable to believe that an individual's loss of United States citizenship would, but for this section, result in a substantial reduction for the taxable year in the taxes on his probable income for such year, the burden of proving for such taxable year that such loss of citizenship did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle B shall be on such individual."

(2) The table of sections for subpart A of part II of subchapter N of chapter 1 (relating to nonresident alien individuals) is amended by striking out the item relating to section 877 and inserting in lieu thereof the following:

"Sec. 877. Expatriation to avoid tax.
"Sec. 878. Foreign educational, charitable, and certain other exempt organizations."

(f) PARTIAL EXCLUSION OF DIVIDENDS.—Subsection (d) of section 116 (relating to certain nonresident aliens ineligible for exclusion) is amended to read as follows:

"(d) CERTAIN NONRESIDENT ALIENS INELIGIBLE FOR EXCLUSION.—In the case of a nonresident alien individual, subsection (a) shall apply only—

"(1) in determining the tax imposed for the taxable year pursuant to section 871(b)(1) and only in respect of dividends which are effectively connected with the conduct of a trade or business within the United States, or

"(2) in determining the tax imposed for the taxable year pursuant to section 877(b)."

(g) WITHHOLDING OF TAX ON NONRESIDENT ALIENS.—Section 1441 (relating to withholding of tax on nonresident aliens) is amended—

(1) by striking out "(except interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States)" in subsection (b);

(2) by striking out "and amounts described in section 402(a)(2)" and all that follows in the first sentence of subsection (b) and inserting in lieu thereof "and gains described in section 402(a)(2), 403(a)(2), or 631(b) or (c), and gains on transfers described in section 1235.";

(3) by striking out paragraph (1) of subsection (c) and inserting in lieu thereof the following new paragraph:

"(1) INCOME CONNECTED WITH UNITED STATES BUSINESS.—No deduction or withholding under subsection (a) shall be required in the case of any item of income (other than compensation for personal services) which is effectively connected with the conduct of a trade or business within the United States and on which a tax is imposed for the taxable year pursuant to section 871(b)(1).";

(4) by amending paragraph (4) of subsection (c) to read as follows:

"(4) COMPENSATION OF CERTAIN ALIENS.—Under regulations prescribed by the Secretary or his delegate, compensation for personal services may be exempted from deduction and withholding under subsection (a)."; and

(5) by striking out "amounts described in section 402(a)(2), section 403(a)(2), section 631 (b) and (c), and section 1235, which are considered to be gains from the sale or exchange of capital assets," in paragraph (5) of subsection (c) and inserting in lieu thereof "gains described in section 402 (a)(2), 403(a)(2), or 631 (b) or (c), and gains on transfers described in section 1235,", and by striking out "proceeds from such sale or exchange," in such paragraph and inserting in lieu thereof "amount payable,".

(h) LIABILITY FOR WITHHELD TAX.—Section 1461 (relating to return and payment of withheld tax) is amended to read as follows:

"SEC. 1461. LIABILITY FOR WITHHELD TAX.

"Every person required to deduct and withhold any tax under this chapter is hereby made liable for such tax and is hereby indemnified against the claims and demands of any person for the amount of any payments made in accordance with the provisions of this chapter."

(i) DECLARATION OF ESTIMATED INCOME TAX BY INDIVIDUALS.—Section 6015 (relating to declaration of estimated income tax by individuals) is amended—

(1) by striking out that portion of subsection (a) which precedes paragraph (1) and inserting in lieu thereof the following:

"(a) REQUIREMENT OF DECLARATION.—Except as otherwise provided in subsection (i), every individual shall make a declaration of his estimated tax for the taxable year if—";

(2) by redesignating subsection (i) as subsection (j); and

(3) by inserting after subsection (h) the following new subsection:

"(i) NONRESIDENT ALIEN INDIVIDUALS.—No declaration shall be required to be required to be made under this section by a nonresident alien individual unless—

"(1) withholding under chapter 24 is made applicable to the wages, as defined in section 3401(a), of such individual,

"(2) such individual has income (other than compensation for personal services subject to deduction and withholding under section 1441) which is effectively connected with the conduct of a trade or business within the United States, or

"(3) such individual is a resident of Puerto Rico during the entire taxable year."

(j) GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE REALTY.—The second sentence of paragraph (3) of section 1250(d) (relating to certain tax-free transactions) is amended to read as follows: "This paragraph shall not apply to—

"(A) a disposition to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by this chapter, or

"(B) a transfer of property by a nonresident alien individual, a foreign estate or trust, or a foreign partnership, to a domestic corporation in exchange for stock or securities in such corporation in a transaction to which section 351 applies."

(k) COLLECTION OF INCOME TAX AT SOURCE ON WAGES.—Subsection (a) of section 3401 (relating to definition of wages for purposes of collection of income tax at source) is amended by striking out paragraphs (6) and (7) and inserting in lieu thereof the following:

"(6) for such services, performed by a nonresident alien individual, as may be designated by regulations prescribed by the Secretary or his delegate; or".

(l) DEFINITION OF FOREIGN ESTATE OR TRUST.—Section 7701(a)(31) (defining foreign estate or trust) is amended by striking out "from sources without the United States" and inserting in lieu thereof ", from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States,".

(m) CONFORMING AMENDMENT.—The first sentence of section 932(a) (relating to citizens of possessions of the United States) is amended to read as follows: "Any individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United States shall be subject to taxation under this subtitle in the same manner and subject to the same conditions as in the case of a nonresident alien individual."

(n) Effective Dates.—

(1) The amendments made by this section (other than the amendments made by subsections (h) and (k)) shall apply with respect to taxable years beginning after December 31, 1966.

(2) The amendments made by subsection (h) shall apply with respect to payments occurring after December 31, 1966.

(3) The amendments made by subsection (k) shall apply with respect to remuneration paid after December 31, 1966.

SEC. 4. FOREIGN CORPORATIONS.

(a) Tax on Income Not Connected With United States Business.—Section 881 (relating to tax on foreign corporations not engaged in business in the United States) is amended to read as follows:

"SEC. 881. INCOME OF FOREIGN CORPORATIONS NOT CONNECTED WITH UNITED STATES BUSINESS.

"(a) Imposition of Tax.—There is hereby imposed for each taxable year a tax of 30 percent of the amount received from sources within the United States by a foreign corporation as—

"(1) interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income,

"(2) gains described in section 631 (b) or (c), and

"(3) amounts which under section 341, or under section 1232 (in the case of bonds or other evidences of indebtedness issued after September 28, 1965), are treated as gains from the sale or exchange of property which is not a capital asset,

but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States.

"(b) Doubling of Tax.—

"For doubling of tax on corporations of certain foreign countries, see section 891."

(b) Tax on Income Connected With United States Business.—

(1) Section 882 (relating to tax on resident foreign corporations) is amended to read as follows:

"SEC. 882. INCOME OF FOREIGN CORPORATIONS CONNECTED WITH UNITED STATES BUSINESS.

"(a) Normal Tax and Surtax.—

"(1) Imposition of tax.—A foreign corporation engaged in trade or business within the United States during the taxable year shall be taxable as provided in section 11 or 1201(a) on its taxable income which is effectively connected with the conduct of a trade or business within the United States.

"(2) Determination of taxable income.—In determining taxable income for purposes of paragraph (1), gross income includes only gross income which is effectively connected with the conduct of a trade or business within the United States.

"(b) Gross Income.—In the case of a foreign corporation, gross income includes only—

"(1) 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 within the United States, and

"(2) gross income which is effectively connected with the conduct of a trade or business within the United States.

"(c) Allowance of Deductions and Credits.—

"(1) Allocation of deductions.—

"(A) General rule.—In the case of a foreign corporation, the deductions shall be allowed only for purposes of subsection (a) and (except as provided by subparagraph (B)) only if and to the extent that they are connected with income which is effectively connected with the conduct of a trade or business within the United States; and the proper apportionment and allocation of the deductions for this purpose shall be determined as provided in regulations prescribed by the Secretary or his delegate.

"(B) Charitable contributions.—The deduction for charitable contributions and gifts provided by section 170 shall be allowed whether or not connected with income which is effectively connected with the conduct of a trade or business within the United States.

"(2) DEDUCTIONS AND CREDITS ALLOWED ONLY IF RETURN FILED.—A foreign corporation shall receive the benefit of the deductions and credits allowed to it in this subtitle only by filing or causing to be filed with the Secretary or his delegate a true and accurate return, in the manner prescribed in subtitle F, including therein all the information which the Secretary or his delegate may deem necessary for the calculation of such deductions and credits. This paragraph shall not be construed to deny the credit provided by section 32 for tax withheld at source or the credit provided by section 39 for certain uses of gasoline and lubricating oil.

"(3) FOREIGN TAX CREDIT.—Except as provided by section 906, foreign corporations shall not be allowed the credit against the tax for taxes of foreign countries and possessions of the United States allowed by section 901.

"(4) CROSS REFERENCE.—

"For rule that certain foreign taxes are not to be taken into account in determining deduction or credit, see section 906(b)(1).

"(d) ELECTION TO TREAT REAL PROPERTY INCOME AS INCOME CONNECTED WITH UNITED STATES BUSINESS.—

"(1) IN GENERAL.—A foreign corporation which during the taxable year derives any income—

"(A) from real property located in the United States, or from any interest in such real property, including (i) gains from the sale or exchange of real property or an interest therein, (ii) rents or royalties from mines, wells, or other natural deposits, and (iii) gains described in section 631 (b) or (c), and

"(B) which, but for this subsection, would not be treated as income effectively connected with the conduct of a trade or business within the United States,

may elect for such taxable year to treat all such income as income which is effectively connected with the conduct of a trade or business within the United States. In such case, such income shall be taxable as provided in subsection (a) (1) whether or not such corporation is engaged in trade or business within the United States during the taxable year. An election under this paragraph for any taxable year shall remain in effect for all subsequent taxable years, except that it may be revoked with the consent of the Secretary or his delegate with respect to any taxable year.

"(2) ELECTION AFTER REVOCATION, ETC.—Paragraphs (2) and (3) of section 871 (d) shall apply in respect of elections under this subsection in the same manner and to the same extent as they apply in respect of elections under section 871 (d).

"(e) RETURNS OF TAX BY AGENT.—If any foreign corporation has no office or place of business in the United States but has an agent in the United States, the return required under section 6012 shall be made by the agent."

(2) (A) Subsection (e) of section 11 (relating to exceptions from tax on corporations) is amended by inserting "or" at the end of paragraph (2), by striking out ", or" at the end of paragraph (3) and inserting a period in lieu thereof, and by striking out paragraph (4).

(B) Section 11 (relating to tax on corporations) is amended by adding at the end thereof the following new subsection:

"(f) FOREIGN CORPORATIONS.—In the case of a foreign corporation, the tax imposed by subsection (a) shall apply only as provided by section 882."

(3) The table of sections for subpart B of part II of subchapter N of chapter 1 is amended by striking out the items relating to sections 881 and 882 and inserting in lieu thereof the following:

"Sec. 881. Income of foreign corporations not connected with United States business.
"Sec. 882. Income of foreign corporations connected with United States business."

(c) WITHHOLDING OF TAX ON FOREIGN CORPORATIONS.—Section 1442 (relating to withholding of tax on foreign corporations) is amended to read as follows:

"SEC. 1442. WITHHOLDING OF TAX ON FOREIGN CORPORATIONS.

"(a) GENERAL RULE.—In the case of foreign corporations subject to taxation under this subtitle, there shall be deducted and withheld at the source in the same manner and on the same items of income as is provided in section 1441 or section 1451 a tax equal to 30 percent thereof; except that, in the case of interest described in section 1451 (relating to tax-free covenant bonds), the deduction and withholding shall be at the rate specified therein. For purposes of the preceding sentence, the reference in section 1441(c)(1) to section 871(b)(1) shall be treated as referring to section 842 or section 882(a), as the case may be.

"(b) EXEMPTION.—Subject to such terms and conditions as may be provided by regulations prescribed by the Secretary or his delegate, subsection (a) shall not apply in the case of a foreign corporation engaged in trade or business within the United States if the Secretary or his delegate determines that the requirements of subsection (a) imposes an undue administrative burden and that the collection of the tax imposed by section 881 on such corporation will not be jeopardized by the exemption."

(d) DIVIDENDS RECEIVED FROM CERTAIN FOREIGN CORPORATIONS.—Subsection (a) of section 245 (relating to the allowance of a deduction in respect of dividends received from a foreign corporation) is amended—

(1) by striking out "and has derived 50 percent or more of its gross income from sources within the United States," in that portion of subsection (a) which precedes paragraph (1) and by inserting in lieu thereof "and if 50 percent or more of the gross income of such corporation from all sources for such period is effectively connected with the conduct of a trade or business within the United States,";

(2) by striking out "from sources within the United States" in paragraph (1) and inserting in lieu thereof "which is effectively connected with the conduct of a trade or business within the United States";

(3) by striking out "from sources within the United States" in paragraph (2) and inserting in lieu thereof ", which is effectively connected with the conduct of a trade or business within the United States,"; and

(4) by adding after paragraph (2) the following new sentence:

"For purposes of this subsection, the gross income of the foreign corporation for any period before the first taxable year beginning after December 31, 1966, which is effectively connected with the conduct of a trade or business within the United States is an amount equal to the gross income for such period from sources within the United States."

(e) UNRELATED BUSINESS TAXABLE INCOME.—The last sentence of section 512(a) (relating to definition) is amended to read as follows: "In the case of an organization described in section 511 which is a foreign organization, the unrelated business taxable income shall be its unrelated business taxable income which is effectively connected with the conduct of a trade or business within the United States."

(f) CORPORATIONS SUBJECT TO PERSONAL HOLDING COMPANY TAX.—Paragraph (7) of section 542(c) (relating to corporations not subject to the personal holding company tax) is amended to read as follows:

"(7) a foreign corporation, if all of its stock outstanding during the last half of the taxable year is owned by nonresident alien individuals, whether directly or indirectly through foreign estates, foreign trusts, foreign partnerships, or other foreign corporations;".

(g) AMENDMENTS WITH RESPECT TO FOREIGN CORPORATIONS CARRYING ON INSURANCE BUSINESS IN UNITED STATES.—

(1) Section 842 (relating to computation of gross income) is amended to read as follows:

"SEC. 842. FOREIGN CORPORATIONS CARRYING ON INSURANCE BUSINESS.

"If a foreign corporation carrying on an insurance business within the United States would qualify under part I, II, or III of this subchapter for the taxable year if (without regard to income not effectively connected with the conduct of any trade or business within the United States) it were a domestic corporation, such corporation shall be taxable under such part on its income effectively connected with its conduct of any trade or business within the United States. With respect to the remainder of its income, which is from sources within the United States, such a foreign corporation shall be taxable as provided in section 881."

(2) The table of sections for part IV of subchapter L of chapter 1 is amended by striking out the item relating to section 842 and inserting in lieu thereof the following:

"Sec. 842. Foreign corporations carrying on insurance business."

(3) Section 819 (relating to foreign life insurance companies) is amended—

(A) by striking out subsections (a) and (d) and by redesignating subsections (b) and (c) as subsections (a) and (b),

(B) by striking out "In the case of any company described in subsection (a)," in subsection (a)(1) (as redesignated by subparagraph (A)) and inserting in lieu thereof "In the case of any foreign corporation taxable under this part,",

(C) by striking out "subsection (c)" in the last sentence of subsection (a)(2) (as redesignated by subparagraph (A)) and inserting in lieu thereof "subsection (b)",

(D) by adding at the end of subsection (a) (as redesignated by subparagraph (A)) the following new paragraph:

"(3) REDUCTION OF SECTION 881 TAX.—In the case of any foreign corporation taxable under this part, there shall be determined—

"(A) the amount which would be subject to tax under section 881 if the amount taxable under such section were determined without regard to sections 103 and 894, and

"(B) the amount of the reduction provided by paragraph (1).

The tax under section 881 (determined without regard to this paragraph) shall be reduced (but not below zero) by an amount which is the same proportion of such tax as the amount referred to in subparagraph (B) is of the amount referred to in subparagraph (A); but such reduction in tax shall not exceed the increase in tax under this part by reason of the reduction provided by paragraph (1).",

(E) by striking out "for purposes of subsection (a)" each place it appears in subsection (b) (as redesignated by subparagraph (A)) and inserting in lieu thereof "with respect to a foreign corporation",

(F) by striking out "foreign life insurance company" each place it appears in such subsection (b) and inserting in lieu thereof "foreign corporation",

(G) by striking out "subsection (b)(2)(A)" each place it appears in such subsection (b) and inserting in lieu thereof "subsection (a)(2)(A)",

(H) by striking out "subsection (b)(2)(B)" in paragraph (2)(B)(ii) of such subsection (b) and inserting in lieu thereof "subsection (a)(2)(B)", and

(I) by adding at the end thereof the following new subsection:

"(c) CROSS REFERENCE.—

"For taxation of foreign corporations carrying on life insurance business within the United States, see section 842."

(4) Section 821 (relating to tax on mutual insurance companies to which part II applies) is amended—

(A) by striking out subsection (e) and by redesignating subsections (f) and (g) as subsections (e) and (f), and

(B) by adding at the end of subsection (f) (as redesignated by subparagraph (A)) the following:

"(3) For taxation of foreign corporations carrying on an insurance business within the United States, see section 842."

(5) Section 822 (relating to determination of taxable investment income) is amended by striking out subsection (e) and by redesignating subsection (f) as subsection (e).

(6) Section 831 (relating to tax on certain other insurance companies) is amended—

(A) by striking out subsection (b) and by redesignating subsection (c) as subsection (b), and

(B) by amending subsection (d) to read as follows:

"(c) CROSS REFERENCES.—

"(1) For alternative tax in case of capital gains, see section 1201(a).

"(2) For taxation of foreign corporations carrying on an insurance business within the United States, see section 842."

(7) Section 832 (relating to insurance company taxable income) is amended by striking out subsection (d) and by redesignating subsection (e) as subsection (d).

(8) The second sentence of section 841 (relating to credit for foreign taxes) is amended by striking out "sentence," and inserting in lieu thereof "sentence (and for purposes of applying section 906 with respect to a foreign corporation subject to tax under this subchapter),".

(h) SUBPART F INCOME.—Section 952(b) (relating to exclusion of United States income) is amended to read as follows:

"(b) EXCLUSION OF UNITED STATES INCOME.—In the case of a controlled foreign corporation, subpart F income does not include any item of income from sources within the United States which is effectively connected with the conduct by such corporation of a trade or business within the United States unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a treaty obligation of the United States."

(i) GAIN FROM CERTAIN SALES OR EXCHANGES OF STOCK IN CERTAIN FOREIGN CORPORATIONS.—Paragraph (4) of section 1248 (d) (relating to exclusions from earnings and profits) is amended to read as follows:

"(4) UNITED STATES INCOME.—Any item includible in gross of the foreign corporation under this chapter—

"(A) for any taxable year beginning before January 1, 1967, as income derived from sources within the United States of a foreign corporation engaged in trade or business within the United States, or

"(B) for any taxable year beginning after December 31, 1966, as income effectively connected with the conduct by such corporation of a trade or business within the United States.

This paragraph shall not apply with respect to any item which is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a treaty obligation of the United States."

(j) DECLARATION OF ESTIMATED INCOME TAX BY CORPORATIONS.—Section 6016 (relating to declarations of estimated income tax by corporations) is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

"(f) CERTAIN FOREIGN CORPORATIONS.—For purposes of this section and section 6655, in the case of a foreign corporation subject to taxation under section 11 or 1201(a), or under subchapter L of chapter 1, the tax imposed by section 881 shall be treated as a tax imposed by section 11."

(k) TECHNICAL AMENDMENTS.—

(1) Section 884 is amended to read as follows:

"SEC. 884. CROSS REFERENCES.

"(1) For special provisions relating to unrelated business income of foreign educational, charitable, and certain other exempt organizations, see section 512(a).

"(2) For special provisions relating to foreign corporations carrying on an insurance business within the United States, see section 842.

"(3) For rules applicable in determining whether any foreign corporation is engaged in trade or business within the United States, see section 864(b).

"(4) For reinstatement of pre-1967 income tax provisions in the case of corporations of certain foreign countries, see section 896.

"(5) For allowance of credit against the tax in case of a foreign corporation having income effectively connected with the conduct of a trade or business within the United States, see section 906.

"(6) For withholding at source of tax on income of foreign corporations, see section 1442."

(2) Section 953(b)(3)(F) is amended by striking out "832(b)(5)" and inserting in lieu thereof "832(c)(5)".

(3) Section 1249(a) is amended by striking out "Except as provided in subsection (c), gain" and inserting in lieu thereof "Gain".

(l) EFFECTIVE DATES.—The amendments made by this section (other than subsection (i)) shall apply with respect to taxable years beginning after December 31, 1966. The amendment made by subsection (i) shall apply with respect to sales or exchanges occurring after December 31, 1966.

SEC. 5. SPECIAL TAX PROVISIONS.

(a) INCOME AFFECTED BY TREATY.—Section 894 (relating to income exempt under treaties) is amended to read as follows:

"SEC. 894. INCOME AFFECTED BY TREATY.

"(a) INCOME EXEMPT UNDER TREATY.—Income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.

"(b) PERMANENT ESTABLISHMENT IN UNITED STATES.—For purposes of applying any exemption from, or reduction of, any tax provided by any treaty to which the United States is a party with respect to income which is not effectively connected with the conduct of a trade or business within the United States, a nonresident alien individual or a foreign corporation shall be deemed not to have a permanent establishment in the United States at any time during the taxable year. This subsection shall not apply in respect of the tax computed under section 877(b)."

(b) APPLICATION OF PRE-1967 INCOME TAX PROVISIONS.—Subpart C of part II of subchapter N of chapter 1 (relating to miscellaneous provisions applicable to nonresident aliens and foreign corporations) is amended by adding at the end thereof the following new section:

"SEC. 896. APPLICATION OF PRE-1967 INCOME TAX PROVISIONS.

"(a) IMPOSITION OF MORE BURDENSOME TAXES BY FOREIGN COUNTRY.—Whenever the President finds that—

"(1) under the laws of any foreign country, considering the tax system of such foreign country, citizens of the United States not residents of such foreign country or domestic corporations are being subjected to more burdensome taxes, on any item of income received by such citizens or corporations from sources within such foreign country, than taxes imposed by the provisions of this subtitle on similar income derived from sources within the United States by residents or corporations of such foreign country.

"(2) such foreign country, when requested by the United States to do so, has not acted to revise or reduce such taxes so that they are no more burdensome than taxes imposed by the provisions of this subtitle on similar income derived from sources within the United States by residents or corporations of such foreign country, and

"(3) it is in the public interest to apply pre-1967 tax provisions in accordance with the provisions of this section to residents or corporations of such foreign country,

the President shall proclaim that the tax on such similar income derived from sources within the United States by residents or corporations of such foreign country shall, for taxable years beginning after such proclamation, be determined under this subtitle without regard to amendments made to this subchapter and chapter 3 on or after the date of enactment of this section.

"(b) ALLEVIATION OF MORE BURDENSOME TAXES.—Whenever the President finds that the laws of any foreign country with respect to which the President has made a proclamation under subsection (a) have been modified so that citizens of the United States not residents of such foreign country or domestic corporations are no longer subject to more burdensome taxes on such item of income derived by such citizens or corporations from sources within such foreign country, he shall proclaim that the tax on such similar income derived from sources within the United States by residents or corporations of such foreign country shall, for any taxable year beginning after such proclamation, be determined under this subtitle without regard to subsection (a).

"(c) NOTIFICATION OF CONGRESS REQUIRED.—No proclamation shall be issued by the President pursuant to this section unless, at least 30 days prior to such proclamation, he has notified the Senate and the House of Representatives of his intention to issue such proclamation.

"(d) IMPLEMENTATION BY REGULATIONS.—The Secretary or his delegate shall prescribe such regulations as he deems necessary or appropriate to implement this section."

(c) CLERICAL AMENDMENTS.—The table of sections for subpart C of part II of subchapter N of chapter 1 is amended—

(1) by striking out the item relating to section 894 and inserting in lieu thereof

"Sec. 894. Income affected by treaty.";

(2) by adding at the end of such table the following:

"Sec. 896. Application of pre-1967 income tax provisions."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to taxable years beginning after December 31, 1966.

SEC. 6. FOREIGN TAX CREDIT.

(a) ALLOWANCE OF CREDIT TO CERTAIN NONRESIDENT ALIENS AND FOREIGN CORPORATIONS.—

(1) Subpart A of part III of subchapter N of chapter 1 (relating to foreign tax credit) is amended by adding at the end thereof the following new section:

"SEC. 906. NONRESIDENT ALIEN INDIVIDUALS AND FOREIGN CORPORATIONS.

"(a) ALLOWANCE OF CREDIT.—A nonresident alien individual or a foreign corporation engaged in trade or business within the United States during the taxable year shall be allowed a credit under section 901 for the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year (or deemed, under section 902, paid or accrued during the taxable year) to any foreign country or possession of the United States with respect to income effectively connected with the conduct of a trade or business within the United States.

"(b) SPECIAL RULES.—

"(1) For purposes of subsection (a) and for purposes of determining the deductions allowable under sections 873(a) and 882(c), in determining the amount of any tax paid or accrued to any foreign country or possession there shall not be taken into account any amount of tax to the extent the tax so paid or accrued is imposed with respect to income which would not be taxed by such foreign country or possession but for the fact that—

"(A) in the case of a nonresident alien individual, such individual is a citizen or resident of such foreign country or possession, or

"(B) in the case of a foreign corporation, such corporation was created or organized under the law of such foreign country or possession or is domiciled for tax purposes in such country or possession.

"(2) For purposes of subsection (a), in applying section 904 the taxpayer's taxable income shall be treated as consisting only of the taxable income effectively connected with the taxpayer's conduct of a trade or business within the United States.

"(3) The credit allowed pursuant to subsection (a) shall not be allowed against any tax imposed by section 871(a) (relating to income of nonresident alien individual not connected with United States business) or 881 (relating to income of foreign corporations not connected with United States business).

"(4) For purposes of sections 902(a) and 78, a foreign corporation choosing the benefits of this subpart which receives dividends shall, with respect to such dividends, be treated as a domestic corporation."

(2) The table of sections for such subpart A is amended by adding at the end thereof the following:

"Sec. 906. Nonresident alien individuals and foreign corporations."

(3) Section 874(c) is amended by striking out

"(c) FOREIGN TAX CREDIT NOT ALLOWED.—A nonresident" and inserting in lieu thereof the following:

"(c) FOREIGN TAX CREDIT.—Except as provided in section 906, a nonresident".

(4) Subsection (b) of section 901 (relating to amount allowed) is amended by redesignating paragraph (4) as paragraph (5), and by inserting after paragraph (3) the following new paragraph:

"(4) NONRESIDENT ALIEN INDIVIDUALS AND FOREIGN CORPORATIONS.—In the case of any nonresident alien individual not described in section 876 and in the case of any foreign corporation, the amount determined pursuant to section 906; and".

(5) Paragraph (5) (as redesignated) of section 901(b) is amended by striking out "or (3)," and inserting in lieu thereof "(3), or (4),".

(6) The amendments made by this subsection shall apply with respect to taxable years beginning after December 31, 1966. In applying section 904 of the Internal Revenue Code of 1954 with respect to section 906 of such Code, no amount may be carried from or to any taxable year beginning before January 1, 1967, and no such year shall be taken into account.

(b) ALIEN RESIDENTS OF THE UNITED STATES OR PUERTO RICO.—

(1) Paragraph (3) of section 901(b) (relating to amount of foreign tax credit allowed in case of alien resident of the United States or Puerto Rico) is amended by striking out ", if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country".

(2) Section 901 is amended by redesignating subsections (c) and (d) as subsections (d) and (e), and by inserting after subsection (b) the following new subsection:

"(c) SIMILAR CREDIT REQUIRED FOR CERTAIN ALIEN RESIDENTS.—Whenever the President finds that—

"(1) a foreign country, in imposing income, war profits, and excess profits taxes, does not allow to citizens of the United States residing in such foreign country a credit for any such taxes paid or accrued to the United States or any foreign country, as the case may be, similar to the credit allowed under subsection (b) (3),

"(2) such foreign country, when requested by the United States to do so, has not acted to provide such a similar credit to citizens of the United States residing in such foreign country, and

"(3) it is in the public interest to allow the credit under subsection (b) (3) to citizens or subjects of such foreign country only if it allows such a similar credit to citizens of the United States residing in such foreign country,

the President shall proclaim that, for taxable years beginning while the proclamation remains in effect, the credit under subsection (b) (3) shall be allowed to citizens or subjects of such foreign country only if such foreign country, in imposing income, war profits, and excess profits taxes, allows to citizens of the United States residing in such foreign country such a similar credit."

(3) Section 2014 (relating to credit for foreign death taxes) is amended by striking out the second sentence of subsection (a), and by adding at the end of such section the following new subsection:

"(h) SIMILAR CREDIT REQUIRED FOR CERTAIN ALIEN RESIDENTS.—Whenever the President finds that—

"(1) a foreign country, in imposing estate, inheritance, legacy, or succession taxes, does not allow to citizens of the United States resident in such foreign country at the time of death a credit similar to the credit allowed under subsection (a),

"(2) such foreign country, when requested by the United States to do so, has not acted to provide such a similar credit in the case of citizens of the United States resident in such foreign country at the time of death, and

"(3) it is in the public interest to allow the credit under subsection (a) in the case of citizens or subjects of such foreign country only if it allows such a similar credit in the case of citizens of the United States resident in such foreign country at the time of death,

the President shall proclaim that, in the case of citizens or subjects of such foreign country dying while the proclamation remains in effect, the credit under subsection (a) shall be allowed only if such foreign country allows such a similar credit in the case of citizens of the United States resident in such foreign country at the time of death."

(4) The amendments made by this subsection (other than paragraph (3)) shall apply with respect to taxable years beginning after December 31, 1966. The amendment made by paragraph (3) shall apply with respect to estates of decedents dying after the date of the enactment of this Act.

SEC. 7. AMENDMENT TO PRESERVE EXISTING LAW ON DEDUCTIONS UNDER SECTION 931.

(a) DEDUCTIONS.—Subsection (d) of section 931 (relating to deductions) is amended to read as follows:

"(d) DEDUCTIONS.—

"(1) GENERAL RULE.—Except as otherwise provided in this subsection and subsection (e), in the case of persons entitled to the benefits of this section the deductions shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined as provided in part I, under regulations prescribed by the Secretary or his delegate.

"(2) EXCEPTIONS.—The following deductions shall be allowed whether or not they are connected with income from sources within the United States:

"(A) The deduction, for losses not connected with the trade or business if incurred in transactions entered into for profit, allowed by section 165(c)(2), but only if the profit, if such transaction had resulted in a profit, would be taxable under this subtitle.

"(B) The deduction, for losses of property not connected with the trade or business if arising from certain casualties or theft, allowed by section 165(c)(3), but only if the loss is of property within the United States.

"(C) The deduction for charitable contributions and gifts allowed by section 170.

"(3) DEDUCTION DISALLOWED.—

"For disallowance of standard deduction, see section 142(b)(2)."

(b) EFFECTIVE DATE.—The amendment made by this section shall apply with respect to taxable years beginning after December 31, 1966.

SEC. 8. ESTATES OF NONRESIDENTS NOT CITIZENS.

(a) RATE OF TAX.—Subsection (a) of section 2101 (relating to tax imposed in case of estates of nonresidents not citizens) is amended to read as follows:

"(a) RATE OF TAX.—Except as provided in section 2107, a tax computed in accordance with the following table is hereby imposed on the transfer of the taxable estate, determined as provided in section 2106, of every decedent nonresident not a citizen of the United States:

"If the taxable estate is:	The tax shall be:
Not over $100,000	5% of the taxable estate.
Over $100,000 but not over $500,000	$5,000, plus 10% of excess over $100,000.
Over $500,000 but not over $1,000,000	$45,000, plus 15% of excess over $500,000.
Over $1,000,000 but not over $2,000,000	$120,000, plus 20% of excess over $1,000,000.
Over $2,000,000	$320,000, plus 25% of excess over $2,000,000."

(b) CREDITS AGAINST TAX.—Section 2102 (relating to credits allowed against estate tax) is amended to read as follows:

"SEC. 2102. CREDITS AGAINST TAX.

"(a) IN GENERAL.—The tax imposed by section 2101 shall be credited with the amount which bears the same ratio to the credit computed as provided in section to State death taxes, gift tax, and tax on prior transfers), subject to the special limitation provided in subsection (b).

"(b) SPECIAL LIMITATION.—The maximum credit allowed under section 2011 against the tax imposed by section 2101 for State death taxes paid shall be an amount which bears the same ratio to the credit computed as provided in section 2011(b) as the value of the property, as determined for purposes of this chapter, upon which State death taxes were paid and which is included in the gross estate under section 2103 bears to the value of the total gross estate under section 2103. For purposes of this subsection, the term 'State death taxes' means the taxes described in section 2011(a)."

(c) PROPERTY WITHIN THE UNITED STATES.—Section 2104 (relating to property within the United States) is amended by adding at the end thereof the following new subsection:

"(c) DEBT OBLIGATIONS.—For purposes of this subchapter, debt obligations of—

"(1) a United States person, or

"(2) the United States, a State or any political subdivision thereof, or the District of Columbia,

owned by a nonresident not a citizen of the United States shall be deemed property within the United States. This subsection shall not apply to a debt obligation of a domestic corporation if any interest on such obligation, were such interest received by the decedent at the time of his death, would be treated under section 862(a)(1) as income from sources without the United States."

(d) PROPERTY WITHOUT THE UNITED STATES.—Subsection (b) of section 2105 relating to bank deposits) is amended to read as follows:

"(b) DEPOSITS IN CERTAIN FOREIGN BRANCHES.—For purposes of this subchapter, deposits with a foreign branch of a domestic corporation, if such branch is engaged in the commercial banking business, shall not be deemed property within the United States."

(e) DEFINITION OF TAXABLE ESTATE.—Paragraph (3) of section 2106(a) (relating to deduction of exemption from gross estate) is amended to read as follows:

"(3) EXEMPTION.—

"(A) GENERAL RULE.—An exemption of $30,000.

"(B) RESIDENTS OF POSSESSIONS OF THE UNITED STATES.—In the case of a decedent who is considered to be a 'nonresident not a citizen of the United States' under the provisions of section 2209, the exemption shall be the greater of (i) $30,000, or (ii) that proportion of the exemption authorized by section 2052 which the value of that part of the decedent's gross estate which at the time of his death is situated in the United States bears to the value of his entire gross estate wherever situated."

(f) SPECIAL METHODS OF COMPUTING TAX.—Subchapter B of chapter 11 (relating to estates of nonresidents not citizens) is amended by adding at the end thereof the following new sections:

"SEC. 2107. EXPATRIATION TO AVOID TAX.

"(a) RATE OF TAX.—A tax computed in accordance with the table contained in section 2001 is hereby imposed on the transfer of the taxable estate, determined as provided in section 2106, of every decedent nonresident not a citizen of the United States dying after the date of enactment of this section, if after March 8, 1965, and within the 10-year period ending with the date of death such decedent lost United States citizenship, unless such loss did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle A.

"(b) GROSS ESTATE.—For purposes of the tax imposed by subsection (a), the value of the gross estate of every decedent to whom subsection (a) applies shall be determined as provided in section 2103, except that—

"(1) if such decedent owned (within the meaning of section 958(a)) at the time of his death 10 percent or more of the total combined voting power of all classes of stock entitled to vote of a foreign corporation, and

"(2) if such decedent owned (within the meaning of section 958(a)), or is considered to have owned (by applying the ownership rules of section 958(b)), at the time of his death, more than 50 percent of the total combined voting power of all classes of stock entitled to vote of such foreign corporation,

then that proportion of the fair market value of the stock of such foreign corporation owned (within the meaning of section 958(a)) by such decedent at the time of his death, which the fair market value of any assets owned by such foreign corporation and situated in the United States, at the time of his death, bears to the total fair market value of all assets owned by such foreign corporation at the time of his death, shall be included in the gross estate of such decedent. For purposes of the preceding sentence, a decedent shall be treated as owning stock of a foreign corporation at the time of his death if, at the time of a transfer, by trust or otherwise, within the meaning of sections 2035 to 2038, inclusive, he owned such stock.

"(c) CREDITS.—The tax imposed by subsection (a) shall be credited with the amounts determined in accordance with section 2102.

"(d) EXCEPTION FOR LOSS OF CITIZENSHIP FOR CERTAIN CAUSES.—Subsection (a) shall not apply to the transfer of the estate of a decedent whose loss of United States citizenship resulted from the application of section 301(b), 350, or 355 of the Immigration and Nationality Act, as amended (8 U.S.C. 1401(b), 1482, or 1487).

"(e) BURDEN OF PROOF.—If the Secretary or his delegate establishes that it is reasonable to believe that an individual's loss of United States citizenship would, but for this section, result in a substantial reduction in the estate, inheritance, legacy, and succession taxes in respect of the transfer of his estate, the burden of proving that such loss of citizenship did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle A shall be on the executor of such individual's estate.

"SEC. 2108. APPLICATION OF PRE-1967 ESTATE TAX PROVISIONS.

"(a) IMPOSITION OF MORE BURDENSOME TAX BY FOREIGN COUNTRY.—Whenever the President finds that—

"(1) under the laws of any foreign country, considering the tax system of such foreign country, a more burdensome tax is imposed by such foreign country on the transfer of estates of decedents who were citizens of the United States and not residents of such foreign country than the tax imposed by this subchapter on the transfer of estates of decedents who were residents of such foreign country,

"(2) such foreign country, when requested by the United States to do so, has not acted to revise or reduce such tax so that it is no more burdensome than the tax imposed by this subchapter on the transfer of estates of decedents who were residents of such foreign country, and

"(3) it is in the public interest to apply pre-1967 tax provisions in accordance with this section to the transfer of estates of decedents who were residents of such foreign country,

the President shall proclaim that the tax on the transfer of the estate of every decedent who was a resident of such foreign country at the time of his death shall, in the case of decedents dying after the date of such proclamation, be determined under this subchapter without regard to amendments made to sections 2101 (relating to tax imposed), 2102 (relating to credits against tax, and 6018 (relating to estate tax returns) on or after the date of enactment of this section.

"(b) ALLEVIATION OF MORE BURDENSOME TAX.—Whenever the President finds that the laws of any foreign country with respect to which the President has made a proclamation under subsection (a) have been modified so that the tax on the transfer of estates of decedents who were citizens of the United States and not residents of such foreign country is no longer more burdensome than the tax imposed by this subchapter on the transfer of estates of decedents who were residents of such foreign country, he shall proclaim that the tax on the transfer of the estate of every decedent who was a resident of such foreign country at the time of his death shall, in the case of decedents dying after the date of such proclamation, be determined under this subchapter without regard to subsection (a).

"(c) NOTIFICATION OF CONGRESS REQUIRED.—No proclamation shall be issued by the President pursuant to this section unless, at least 30 days prior to such proclamation, he has notified the Senate and the House of Representatives of his intention to issue such proclamation.

"(d) IMPLEMENTATION BY REGULATIONS.—The Secretary or his delegate shall prescribe such regulations as may be necessary or appropriate to implement this section."

(g) ESTATE TAX RETURNS.—Paragraph (2) of section 6018(a) (relating to estates of nonresidents not citizens) is amended by striking out "$2,000" and inserting in lieu thereof "$30,000".

(h) CLERICAL AMENDMENT.—The table of sections for subchapter B of chapter 11 (relating to estates of nonresidents not citizens) is amended by adding at the end thereof the following:

"Sec. 2107. Expatriation to avoid tax.
"Sec. 2108. Application of pre-1967 estate tax provisions."

(i) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to estates of decedents dying after the date of the enactment of this Act.

SEC. 9. TAX ON GIFTS OF NONRESIDENTS NOT CITIZENS.

(a) IMPOSITION OF TAX.—Subsection (a) of section 2501 (relating to general rule for imposition of tax) is amended to read as follows:

"(a) TAXABLE TRANSFERS.—

"(1) GENERAL RULE.—For the calendar year 1955 and each calendar year thereafter a tax, computed as provided in section 2502, is hereby imposed on the transfer of property by gift during such calendar year by any individual, resident or nonresident.

"(2) TRANSFERS OF INTANGIBLE PROPERTY.—Except as provided in paragraph (3), paragraph (1) shall not apply to the transfer of intangible property by a nonresident not a citizen of the United States.

"(3) EXCEPTIONS.—Paragraph (2) shall not apply in the case of a donor who at any time after March 8, 1965, and within the 10-year period ending with the date of transfer lost United States citizenship unless—

"(A) such donor's loss of United States citizenship resulted from the application of section 301(b), 350, or 355 of the Immigration and Nationality Act, as amended (8 U.S.C. 1401(b), 1482, or 1487), or

"(B) such loss did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle A.

"(4) BURDEN OF PROOF.—If the Secretary or his delegate establishes that it is reasonable to believe that an individual's loss of United States citizenship would, but for paragraph (3), result in a substantial reduction for the calendar year in the taxes on the transfer of property by gift, the burden of proving that such loss of citizenship did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle A shall be on such individual."

(b) TRANSFERS IN GENERAL.—Subsection (b) of section 2511 (relating to situs rule for stock in a corporation) is amended to read as follows:

"(b) INTANGIBLE PROPERTY.—For purposes of this chapter, in the case of a nonresident not a citizen of the United States who is excepted from the application of section 2501(a)(2)—

"(1) shares of stock issued by a domestic corporation, and

"(2) debt obligations of—

"(A) a United States person, or

"(B) the United States, a State or any political subdivision thereof, or the District of Columbia,

which are owned by such nonresident shall be deemed to be property situated within the United States."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to the calendar year 1967 and all calendar years thereafter.

SEC. 10. TREATY OBLIGATIONS.

No amendment made by this Act shall apply in any case where its application would be contrary to any treaty obligation of the United States. For purposes of the preceding sentence, the extension of a benefit provided by any amendment made by this Act shall not be deemed to be contrary to a treaty obligation of the United States.

The CHAIRMAN. Our first witness this morning is Mr. Paul D. Seghers, president of the Institute on U.S. Taxation of Foreign Income.

Mr. Seghers, you have been before the committee on occasions in the past. We are always glad to have you with us. For purposes of this record we would appreciate your again identifying yourself.

STATEMENT OF PAUL D. SEGHERS, PRESIDENT, INSTITUTE ON U.S. TAXATION OF FOREIGN INCOME

Mr. SEGHERS. Thank you, Mr. Chairman.

My name is Paul D. Seghers, an attorney of New York City. I am here to represent the Institute on U.S. Taxation of Foreign Income, Inc., of which I am president.

The committee indicated that today it would have limited time to consider the views regarding the new provisions of H.R. 13103 and for this reason I prepared a short oral statement to go right to the point.

First, we wish to compliment this committee on its decision to scrap H.R. 11297 and to substitute H.R. 13103, which has eliminated most of the evils of the former.

We thank the committee for holding this public hearing and for giving us this opportunity to present our views.

H.R. 13103 is very substantially less open to criticism than its predecessor. However, it still retains some of the features that raised the storm of protest that lead to the substitution of the present bill. We oppose these features of the present bill because—

1. It would worsen our balance of payments.
2. It would drive jobs out of this country.
3. It would lead to tax retaliation by other countries.
4. It would further penalize exports of U.S. products.
5. It would add to the complexity and uncertainty of the tax law by substitution of radically new and untried theories.

We believe these are sound reasons why this committee should not approve this bill in its present form. Our written statement sets forth our recommendations which may be thus summarized:

If you decide to retain the "effectively connected" concept for the benefit of foreign investors, then we recommend that you limit its application to them and do not impose it on U.S.-owned corporations.

We believe that before making any such radical changes in long-established principles of taxation and in the rules created in the 1962 Revenue Act, which already penalizes exports, there should be made available to the public:

1. A statement of the reasons for including in this bill the burdensome provisions which are in conflict with its stated purpose.

2. A statement of the revenue effect of these provisions.

3. Adequate time and opportunity to consider the effect of these provisions and the reasons advanced for them and to be heard.

Our views have been stated as briefly as possible so as to allow time to answer questions if any of the members of this committee who are present do not agree with the conclusions I have stated.

Off the record, Mr. Mills.

(Off the record discussion.)

Mr. SEGHERS. 1. This institute heartily agrees with the oft-stated purpose of this bill—to afford tax incentives for investment in the United States by foreigners.

2. Our objection is to this bill being made a vehicle to impose further U.S. tax burdens on U.S. foreign trade, especially U.S. manufacturers exporting their products for sale through foreign subsidiaries.

3. Despite the substantial improvements in the language of the latest bill concerning foreign income "effectively connected" with business activities in the United States, we must continue to insist that that theory is wrong in principle and objectionable.

4. To avoid further handicapping U.S. concerns engaged in foreign trade, it is essential, if the latest proposed "effectively connected" language is retained, to provide that these new provisions are not applicable to foreign corporations majority controlled by U.S. persons. We make no alternative recommendations for improving these very complicated and troublesome provisions, as the one change we recommend will be sufficient to eliminate the danger, which still exists, of harm to U.S. business engaged in foreign trade from the "effectively connected" provisions, even in their present form.

5. The proposed radically new provisions for disallowance of credit for foreign income taxes would, in certain circumstances, result in severe and unjustifiable hardship through double taxation, even if the "effectively connected" provisions were limited as recommended above.

6. We are convinced that the principal objectives of this bill could be achieved by the use of very much simpler and more direct language, and doubt if the provisions of H.R. 13103 regarding U.S. income and activities of foreign-owned foreign corporations, however expressed, would go far toward accomplishing the desired purpose.

1. The objective of H.R. 13103 is heartily approved: This institute heartily approves of the oft-repeated objective of H.R. 13103 (and its predecessors, H.R. 5916 and H.R. 11297)—"to increase foreign in-

vestment in the United States," as expressed in the Treasury Department's March 8, 1965, statement.

This purpose was again stated in the report on H.R. 11297 published by this committee for the use of its members, as follows:

to modernize the present U.S. tax treatment of foreigners and to encourage foreign investment in the United States * * * by removing tax barriers to such investment.

2. Objection to use of H.R. 13103 to burden our foreign trade: H.R. 11297 would have constituted a further oppressive burden on U.S. foreign trade. While H.R. 13103 goes far to avoid this evil, it still presents a threat to all U.S.-owned subsidiaries engaged in foreign trade, especially in the case of U.S. manufacturers exporting and selling their products abroad through such subsidiaries.

Such added burden is in no wise consistent with the purpose of affording incentives for foreign investment in the United States, nor with efforts to encourage export of U.S.-manufactured products.

We make no comments or recommendation herein regarding the possibly adverse effects of H.R. 13103 on foreign-owned foreign corporations. We are concerned here only with adverse effects on U.S. business and the U.S. economy.

Comments regarding specific ways in which this bill would impose added burdens on U.S. businesses engaged in foreign trade are given in statements filed with your committee by other organizations, including the American Bar Association's Section of Taxation and the American Institute of Certified Public Accountants' Committee on Federal Taxation.

Attention also is directed to study entitled: "Sleepers in New Foreign Tax Bill; Drastic Changes Require Immediate Planning," published in the February 1966 issue of the Journal of Taxation.

See also the attached reprint of article: "New Tax Threat for U.S. Exporters" in March 7 issue of Dun & Bradstreet's "Business Abroad," reprint of which is submitted herewith.

3. The radical new "effectively connected" theory is wrong in principle: The feature of H.R. 11297 which led to a storm of protest was the proposal to subject foreign corporations to U.S. tax on income earned by them outside the United States by applying new "effectively connected" theory. That theory seems to be that every foreign corporation should pay U.S. tax on income it earns anywhere in the world outside the United States, if such income is "effectively connected" with business activities in the United States.

The expression (even with its "clarification") is so vague that it would cause endless uncertainty, confusion, and disputes. This is one point on which all who have examined this bill and its predecessor agree. We believe that no amount of "legislative history" could adequately cure this defect.

Although H.R. 13103 has substantially modified the application of this "effectively connected" theory, it still pervades the bill, the phrase being repeated scores of times throughout the first 62 of its 74 pages. The exact meaning of this phrase defies definition.

4. Recommendation limitation of application of the "effectively connected" theory to exclude U.S. controlled corporations: If the purpose of this bill is to afford U.S. tax incentives to foreign invest-

ment in this country, the radical new "effectively connected" theory should not be applicable to U.S. owned and controlled corporations.

As far as U.S. controlled corporations are concerned, this could be accomplished by substituting for the presently proposed new IRC section 882(b) the following:

SEC. 882. INCOME OF FOREIGN CORPORATIONS CONNECTED WITH UNITED STATES BUSINESS.

* * * * * * *

(b) GROSS INCOME.—

1. In the case of a foreign corporation 50 percent or more of the stock of which is owned, directly or indirectly, by United States persons (as defined in section 957(d)), gross incomes includes only gross income from sources within the United States and,

2. In the case of all other foreign corporations, gross income also shall include gross income from sources without the United States which is effectively connected with the conduct of a trade or business within the United States.

We express no opinion as to the effect of this provision upon foreign investor-owned foreign corporations, other than to state that it would take away from them no benefits which they would be able to obtain under the present provisions of H.R. 13103.

Another, simpler method to accomplish exactly the same purpose, with fewer changes in wording of cross-references, would be to reword the proposed new section 864(c)(4)(C) (page 16 of the bill as introduced) as follows:

(C) No income, gain, or loss from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States if it is derived by a foreign corporation, more than 50 percent owned, directly or indirectly, by U.S. persons.

5. Proposed disallowance of credit for uncertain foreign income taxes: H.R. 13103 would disallow credit (or deduction) for uncertain foreign income taxes imposed on a foreign corporation if—

(1) Such taxes were imposed by reason of its place of organization or domicile, or

(2) Such taxes were incurred as a result of steps taken for tax-saving reasons.

It would seem that a mere statement of these tests would be sufficient to condemn them.

The first test would penalize the payment of foreign taxes imposed by a foreign government on the same basis as the United States has always claimed jurisdiction to tax corporations in this country.

The second test is purely subjective and would subject a foreign corporation to double taxation on the basis of what it might otherwise have done, rather what it did.

Others will present to this committee more specific comments and recommendations regarding this proposed provision, which would be in addition to all existing restrictions and limitations on the amount allowable as a foreign tax credit.

Our question is this: In what way would this provision for the disallowance of credit for uncertain foreign income taxes, operate as an incentive for foreign investment in the United States?

6. Desirability of simplification of language and concepts: Doubt as to attractiveness to foreign investors of proposed income tax provisions: We believe that the stated objectives of this bill could be attained more satisfactorily by the use of much simpler language and well-recognized principles.

If it is desired to make radical changes in the half-century old principle of source of income, adequate time should be allowed for that operation. H.R. 13103 provides that it is not to go into effect until 1967.

We doubt that, on balance, the income tax provisions of H.R. 13103 will afford much incentive to foreign investors.

It is beyond the scope of this statement to labor further these points. It is clear that no U.S. businessman relishes the need for a legal opinion as to the possible tax consequences of every shipment of goods to a subsidiary.

I thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Seghers, for coming to the committee and giving us the benefit of your thinking on this matter. Mr. Watts.

Mr. WATTS. I have questions that I have been requested to ask you and that I am interested in, too.

It is your opinion that this legislation would hurt the U.S. balance of payments?

Mr. SEGHERS. Yes, it is my opinion because I feel that it will hurt us in three ways. It will hurt your exports in two ways. It will also hurt employment, all of which will affect our balance of payments.

First, as to the effect on exports of foreign-owned foreign corporations, because that is the simplest and most direct effect of this. There are corporations in this country that are branches of European corporations that operate here to sell goods in the United States, Canada, and Latin America.

Those offices employ substantial staffs. They employ freight handlers, customhouse brokers, and others. If they are to be penalized where they make sales of goods in Latin America they will find some other way to make those sales and cut down their staff in this country.

Instead of directing Latin American sales from here they will direct them from some other point where there will not be such a penalty. New York is probably the most convenient, most efficient place, but it isn't the only place that sales could be directed from. That is one example of interfering with employment.

Now, that would also represent a reduction in exports of U.S. products because such a company that is selling here European products, if they are selling to Latin America you would find that they would also be selling U.S. products because the sales effort used to sell their own European products can also be used efficiently to sell other products in related lines.

It would hurt exports in the case of U.S. exporters because where in effect this law says, "Well, if we don't get you under subpart (f), then we will get you under this provision." I can give an example. H.R. 11297 would have been very easy to demolish. This will only hit the unusual case, but there are unusual cases, and it is the fact that you possibly could be hit here or there that will have a bad psychological effect.

It looks as if the Treasury wants to penalize exports rather than to help them. The case where they could be hit is an unusual situation, but again it is not unheard of.

A foreign subsidiary of a U.S. manufacturer maintains an office here to purchase and ship goods from this country to the country where it is incorporated and where it makes its sales. That income is not subpart (f) income because it is selling within the country of incorporation, but an inquiry comes to the U.S. parent from an adjoining foreign country and the U.S. parent turns it over to the local office of the foreign subsidiary.

They are handling purchasing and they are handling shipments. It is very easy to add the sale to this other country. They make this shipment to the other country. This would be subpart (f).

If the gross income exceeded 30 percent of the total gross income of the foreign subsidiary, but we will assume it doesn't exceed 30 percent, it is incidental. Thirty percent is a rather substantial part of their total gross income. There is a gross profit.

Under existing law that income would not be subject to U.S. tax until brought home. Under this law it might very well be subject immediately to U.S. tax, and when any income of a foreign corporation is subject to U.S. tax it is certain to be subject twice to the same U.S. tax on the same income because when the foreign corporation pays a dividend to its U.S. parent company, that dividend will be subject to U.S. tax again.

The income has been subject to U.S. tax in the hands of the foreign corporation and there is no relief from that situation, such as the foreign tax credit, because a U.S. corporation doesn't get credit for a U.S. tax paid by a foreign subsidiary.

Those are briefly three ways, and above all is the psychological effect that has prevented many small manufacturers in the last 4 years, 5 years, from going into export.

More and more small Middle West manufacturers were going into export and when the 1962 act came and it seemed that the Treasury was determined to penalize exports, they decided they just didn't want to get into the complexities that are involved in subpart (f) and all that that means.

That is a long answer to a question, but I think it is an essential point in the whole picture.

Mr. WATTS. I appreciate that. I think you have covered two of my questions. I have another one.

Why do you think this legislation would be likely to cause retaliation by other countries?

Mr. SEGHERS. Because it would be taxing foreign entities over which we theoretically don't have jurisdiction on income earned by those entities outside the United States and they would say if we can do that they will do the same thing. They will tax U.S. corporations on income not earned within their borders.

Mr. WATTS. Are you saying, if I follow you, because these people outside the United States merely have a sales office here, that we would be imposing a tax on their operation?

Mr. SEGHERS. If the goods were sold here it would be U.S. income, and we don't need this bill. If it admitted these foreign incomes but it is administered out of New York it would be taxable.

Mr. WATTS. Another question.

In what way would legitimate export activities—and I think you have already answered this—of a U.S. manufacturer be burdened by this "effectively connected" concept?

Mr. SEGHERS. I feel that I have fully covered that in my previous answer. I didn't know that you were going to ask that question, but I do believe I fully covered this.

Mr. WATTS. That is all I have, Mr. Chairman.

The CHAIRMAN. Any further questions of Mr. Seghers?

If not, Mr. Seghers, we thank you, sir, for coming to the committee this morning with your views.

Mr. SEGHERS. I thank you very sincerely for the opportunity and I think you have done a magnificient job with this H.R. 13103. I still don't like the concept in it, but it certainly has eliminated most of the evils of the earlier one.

The CHAIRMAN. Thank you, sir.

Mr. SEGHERS. Thank you.

The CHAIRMAN. That completes the hearing this morning and without objection the committee will adjourn.

(Whereupon, at 10:27 a.m. the committee adjourned.)

MATERIAL RECEIVED FOR THE RECORD

(The material which follows includes statements which were submitted for the record in lieu of a personal appearance.)

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS,
New York, N.Y., March 7, 1966.

Hon. WILBUR D. MILLS,
Chairman, House Ways and Means Committee, Longworth House Office Building, Washington, D.C.

DEAR CONGRESSMAN MILLS: On February 24 you issued a release affording interested persons the opportunity to submit comments on the new features of H.R. 13103 prior to the close of business Monday, March 7.

Enclosed for your committee's consideration are the comments developed on H.R. 13103 by the subcommittee on taxation of foreign source income of the institute's committee on Federal taxation. Because of the pressure of time this document has not been considered by the entire committee on Federal taxation, as is our usual practice.

We appreciate this opportunity to present our views.

Very truly yours,

DONALD T. BURNS,
General Chairman, Committee on Federal Taxation.

COMMENTS AND RECOMMENDATIONS REGARDING H.R. 13103

On January 12, 1966, the institute's committee on Federal taxation submitted a statement of comments and recommendations regarding H.R. 11297, the predecessor of subject bill. That statement recommended certain changes in H.R. 11297 which are not reflected in H.R. 13103. We believe that our earlier recommendations are still valid, particularly as they relate to (1) the taxation of foreign source income under the "effectively connected" concept; and (2) the income and estate taxation of deposits in U.S. banks.

We are mindful and appreciative of the fact that H.R. 13103 contains significant modifications of H.R. 11297 in both of these areas. However, the proposed new code section 864(c)(4)(C)(ii) illustrates the complexity inherent in any departure from the traditional source of income rules. This subsection provides that no income, gain, or loss from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States if it "is subpart F income within the meaning of section 952 (a)." We can think of three examples of apparent ambiguities or inconsistencies in this statutory language:

EXAMPLE 1

Section 954(b)(4) of the code provides that foreign base company income (and hence supt. F income) "does not include any item of income * * * if it is established * * * that the * * * organization of the controlled foreign corporation * * * does not have the effect of substantial reduction of * * * taxes."

Query. Does the fact that under section 954(b)(4) the income is not subpart F income mean that the exclusion provided by proposed section 854(c)(4)(C)(ii) does not apply? If so, a company may be taxed under H.R. 13103 on income that is excluded from taxation under the subpart F provisions of the code.

EXAMPLE 2

Under section 954(b)(3) no part of gross income shall be considered as foreign base company income (and hence subpt. F income) if it is less than 30 percent of the gross income of the corporation.

Query. Does this mean that if a corporation avails itself of the 30–70 rules for exclusion of income from taxation under subpart F that the excluded income may therefore be taxable under H.R. 13103 under the same reasoning as in example 1?

EXAMPLE 3

As indicated in previous examples, the proposed bill excludes from effectively connected income, foreign source income which is subpart F income of a controlled foreign corporation. However, in order to be a controlled foreign corporation, it is necessary only that "U.S. shareholders" own more than 50 percent of the stock. Such U.S. shareholders report only their pro rata share of subpart F income.

Query. Would not the exclusion of the entire subpart F income result in failure to subject to tax as much as 49 percent of the effectively connected income; i.e., the 49 percent which is applicable to foreign holders? And would not that portion remain permanently free from U.S. taxation?

We believe that any departure from the traditional source of income rules will create problems and inequities disproportionate to the abuse situations for which a remedy is sought.

COUDERT BROS.,
ATTORNEYS AND COUNSELORS AT LAW,
New York, N.Y., March 4, 1966.

Hon. WILBUR D. MILLS,
Chairman, Committee on Ways and Means, House of Representatives, Washington, D.C.
(Attention: Leo Irwin, Esq., Chief Clerk).

DEAR MR. MILLS: We have noted with interest the proposed changes to the Internal Revenue Code as set forth in H.R. 13103 (Foreign Investors Tax Act of 1965) which substitutes for the earlier proposed H.R. 11297.

Although we are gratified that your committee will schedule a hearing on the proposed act on March 7, 1966, we were, at the same time, dismayed by the scarcity of time for study of the act before the 1-day hearing. Because of the complexity involved in the proposed changes to the Internal Revenue Code, and the fact that further hearings cannot be held due to the heavy schedule of the committee announced in your press release dated February 24, 1966, it is vigorously urged that the proposed act be retained in committee and not submitted to the House in its present form. To us it seems imperative that the proposed act must be thoroughly analyzed and studied, and numerous technical mistakes, hereinafter described, corrected before it can be acted upon.

H.R. 13103 is an unsuccessful attempt to contain or define the concept "effectively connected" introduced in H.R. 11297. It is unsuccessful because it attempts to contain the unknown by use of the unclear. For example, the amendment proposed to section 864 by section 2(d), at page 12, commencing at line 15 of the bill, presents mere general language which will not afford a taxpayer any reasonable certainty. At page 13, line 20, use of a "material factor" concept will not be helpful. Again at page 14, line 2, a mere bookkeeping entry apparently aids in determining whether income is "effectively connected" with a trade or business in the United States, provided one can evaluate qualitatively exactly what "due regard" may mean. Further, on page 14, the sentence commencing on line 3 of the bill apparently changes the source rules set forth in section 861(a)(1)(A) with respect to interest. Under the source section, such interest is treated as income not from sources within the United States. Under the bill this last sentence apparently changes this rule for the purposes of applying the paragraph which sets the rules for determining effective connection with the United States. Paragraph (4) of the amended section 864(c) creates an apparent contradiction to section 864(b)(2) dealing with the determination of whether or not a foreign corporation is engaged in trade or business in the United States. Under section 864(b)(2), a foreign corporation which is or would be a personal holding company, the principal business of which is trading in stocks and securities and which has its principal office in the United States, is not determined to be engaged in the conduct of a trade or business in the United States. However, section 864(c)(4)(B)(ii) apparently is in direct conflict with the former provision since it provides that income, gain or loss, from sources without the United States shall be treated as "effectively connected with the conduct of a trade or business within the United States," where the foreign corporation has an office within the United States and the principal business of the corporation is trading in stock or securities for its own account. This seems to be an obvious, unintentional result. Surely the committee cannot intend to catch foreign source income with this provision.

Furthermore, in section 864(c)(4)(B)(iii) the bill attempts to exclude a sale outside the United States by a foreign corporation from the concept of "effectively connected," only if the taxpayer can establish that a fixed place of business outside of the United States "participated materially" in the sale. No adequate definition of "material participation" is supplied.

Generally, the "effectively connected" concept is so uncertain that it could easily catch within its purview foreign source income of foreign corporations which are subsidiaries of U.S. companies.

Many years of litigation, Internal Revenue Service rulings, and usage and study have given the traditional source rules some relative certainty. We respectfully urge that the "effectively connected" concept be abandoned in its entirety and that any changes in the law be made through and by use of the traditional source rules as a basic and overriding concept.

Respectfully submitted.

COUDERT BROTHERS.

INTERNATIONAL ECONOMIC POLICY ASSOCIATION,
Washington, D.C., March 4, 1966.

Hon. WILBUR D. MILLS,
Chairman, Ways and Means Committee,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: I wish to express the association's appreciation for your scheduling of a hearing on Monday, March 7, on H.R. 13103, the Foreign Investors' Tax Act of 1966, in response to the requests in which IEPA joined.

Our membership feels that the revisions made to limit the application of the concept of income, whether or not from sources from within the United States, "effectively connected" with the conduct of a trade or business within the United States, represent a substantial improvement over the corresponding provisions in H.R. 11297.

This "effectively connected" concept, as you know, is a novel one in that it provides for U.S. taxation of income which heretofore has been considered income from sources without the United States and not taxable by the United States. Our tax experts have feeling of uneasiness about the introduction of such a new concept without knowing where it will lead and how it will be interpreted. They feel, therefore, that it would be helpful and enlightening if the committee's report on H.R. 13103 would explain the tax philosophy and the specific purpose underlying the introduction of this novel concept into the law, and illustrate with examples the types of situations to which it is specifically applicable.

Sincerely yours,

N. R. DANIELIAN, *President.*

MACHINERY & ALLIED PRODUCTS INSTITUTE,
Washington, D.C., March 3, 1966.

Hon. WILBUR D. MILLS,
Chairman, Committee on Ways and Means, House of Representatives,
Washington, D.C.

DEAR MR. CHAIRMAN: The Machinery & Allied Products Institute is gratified by your announcement of a 1-day public hearing on Monday, March 7, on the proposed changes to H.R. 11297, the Foreign Investors Tax Act, as included in

H.R. 13103, a new and revised version of the earlier bill. It is our understanding that the hearing will be confined to a consideration of the new features of the proposed legislation. These include, of course, the revision of the "effectively connected" concept of taxing foreign source income devised during the committee's consideration of the original version of this legislation. H.R. 5916, as to which public hearings were held in the summer of 1965. Since the "effectively connected" concept was not included in H.R. 5916, the hearings last summer did not cover this subject. Accordingly, in its telegram of February 23, MAPI recommended further hearings addressed to this new concept.

Having considered the pertinent provisions relating to "effectively connected"—the language beginning at line 20, page 14, of H.R. 13103—the institute acknowledges that they appear to represent a considerable improvement over the corresponding provisions of H.R. 11297.

Despite this improvement, we are opposed to what appears to us to be the underlying philosophy of the "effectively connected" concept to permit the imposition of U.S. taxation on income earned by a foreign corporation from foreign sources. We think that such taxation by the United States is unsound as a matter of both theory and practical application. For many years, this country has followed the fundamental principle of restricting U.S. taxation on income of foreign corporations to that earned from U.S. sources. We recognize that this principle has been violated by the enactment of subpart F of the Internal Revenue Code—the so-called tax haven provisions of the Revenue Act of 1962. However, even in that instance, adherence to at least the theory was followed because the U.S. tax is imposed not under the foreign corporation directly but on its American parent.

It may be that the Treasury feels that certain income earned by foreign corporations should rightly be considered to be attributable to activities in the United States. If this is the case, the problem should be addressed squarely by proposed amendments to those sections of the code relating to source-of-income determination. Thus, this committee, the Senate Finance Committee, and the Congress as a whole, after appropriate deliberation and public hearings, would be afforded an opportunity to consider this problem directly and to approve or disapprove such proposals on their merits. That course of action seems to u · the way to cope with the problem—if, indeed, there is a problem—as opposed to what is being proposed here—a limited nonrecognition of the foreign source character of the income on the ground that it is "effectively connected" with the United States. The indirect approach suggested by Treasury—in connection with a bill the principal purpose of which is to encourage foreign investment in the United States—is, we submit, clearly not the best way to deal with this point.

Nevertheless, we deeply appreciate the committee's efforts to improve these provisions and its willingness to get public reaction on this subject by scheduling next Monday's hearings, despite a heavy committee work schedule.

Respectfully,

CHARLES W. STEWART,
President.

MANUFACTURING CHEMISTS' ASSOCIATION, INC.,
Washington, D.C., March 7, 1966.

Hon. WILBUR D. MILLS,
Chairman, Committee on Ways and Means, Longworth House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: Reference is made to the press release of February 24, announcing the decision of your committee to conduct a public hearing on Monday, March 7, 1966, on the new features of the revised version of H.R. 11297. On February 28, you introduced H.R. 13103, the printed text of the revised version. This letter embodies the views of the Manufacturing Chemists' Association on these new features for inclusion in the printed record of the hearing.

This association wishes to commend the action of your committee in substantially revising and narrowing the coverage of the provisions which set forth the new concept of taxing foreign corporations on income which is "effectively connected" with the conduct of their trades or businesses in the United States. In particular, we are relieved that all income which is "subpart F income" within the meaning of section 952(a) is specifically excluded. As indicated in our letter of February 23, we were seriously concerned with the broad implications of the new concept in H.R. 11297.

Although the new provisions are much narrower in scope, this association continues to be opposed to the "new features" contained in H.R. 13103 which embody the concept of "effectively connected." This policy of taxing foreign corporations engaged in trade or business more extensively in the future than has been the case for past years is inconsistent with the broad objectives of the Fowler task force which were to remove tax barriers to foreign investment.

With this knowledge as to the broad purpose of the administration in this area, U.S. corporate taxpayers find it hard to understand why a new and novel concept has been adopted in connection with this project which would impose upon U.S.-controlled foreign corporations additional areas of taxable income despite a thorough consideration of this entire subject just a short time ago in 1961 and 1962. The language in H.R. 13103 setting forth the conditions under which income is to be treated as "effectively connected" with the conduct of a trade or business is new and complicated. The net effect of it is to override, in the particular situations covered, the old established principle of taxing foreign corporations engaged in business in the United States only on their U.S. income determined under the traditional source rules.

We believe that this new concept should be deleted from the bill because it is impossible at this time to determine its significance and, also, because it is not necessary to the purposes for which this bill was initiated by the Treasury.

Sincerely.

G. H. DECKER, *President.*

NATIONAL ASSOCIATION OF MANUFACTURERS,
New York, N.Y., March 4, 1966.

Hon. WILBUR D. MILLS,
Chairman, Committee on Ways and Means,
House of Representatives,
Washington, D.C.

MY DEAR MR. CHAIRMAN: Our subcommittee has met this morning to consider the revisions of H.R. 11297 which are now incorporated in H.R. 13103. These were explained in your release of February 24. We think the new bill is a great improvement over the former, and we applaud the quick reaction of the Ways and Means Committee to the concern which business spokesmen have expressed.

As you know, our concern is focused largely on the "effectively connected income" test. The revision excludes subpart F income. We urge that this exclusion be expanded to encompass all foreign source income of controlled foreign corporations.

One reason suggested for objecting to this approach has been that two foreign corporations doing business in the same manner might appear to be taxed differently; that is, one that is completely foreign owned and one which has the appropriate U.S. "persons" as shareholders. But since such corporations are already effectively taxed differently, this would not be a valid objection.

Other objections to this approach include areas which properly can be and are controlled by the application of section 482.

These comments are addressed only to the refinements in this legislation as you requested. Our statement would not be complete, however, without observing that unless this new concept of "effectively connected income" is carefully drawn and applied, it invites a host of questions and uncertainties in the application of existing U.S. source rules. Our understanding is that it is not the intention that H.R. 13103 would change these rules, and perhaps a clear statement to this effect in the report of the Ways and Means Committee would prevent any subsequent misconstruction. These rules are of long standing, and are generally understood. Any proposal which would change them should be subjected to the most careful public consideration before enactment.

We respectfully ask that this letter be made a part of the record of your committee's hearings.

Sincerely,

DONALD H. GLEASON,
Chairman, Subcommittee on International Taxation,
NAM Taxation Committee.

NATIONAL FOREIGN TRADE COUNCIL, INC.,
New York, N.Y., March 7, 1966.

Hon. WILBUR D. MILLS,
Chairman, Committee on Ways and Means,
House of Representatives,
Washington, D.C.

DEAR MR. CHAIRMAN: The National Foreign Trade Council has reviewed the Foreign Investors Tax Act of 1966 (H.R. 13103, 89th Cong., 2d sess.) and, in response to your request, welcomes the opportunity to submit comments concerning it.

You will recall our letter of January 14, 1966, pointed out that certain changes in H.R. 11297, as compared with H.R. 5916, appeared to be contrary to the general policies set forth in the report of the Fowler task force. A copy of this letter is enclosed, which we request be given further consideration and be made a part of the record of H.R. 13103.

In accordance with your specific request, the following comments are confined to the further changes made by H.R. 13103.

The council understands that the committee report will contain examples further clarifying the types of income to be subject to tax under this bill and is pleased to note that the "effectively connected" concept has been substantially narrowed. However, the exceptions provided in the proposed section 864(c) (4) may not be adequate to protect legitimate foreign subsidiaries of U.S. corporations from immediate taxation under this law solely as a result of the activities in the United States of the controlling shareholder.

The exception provided in section 864(c) (4) (C) (i) for dividends, interest, and royalties requires the taxpayer to hold a stockownership of more than 50 percent to qualify. It is believed a 10-percent requirement would be more consonant with the realities of present day foreign investment in view of the fact that many foreign countries do not permit a 50-percent foreign ownership and such a high percentage of foreign ownership would discourage participation by local investors in necessary industries. Furthermore, the suggested 10-percent stockownership requirement would be consistent with the stockownership requirement for qualified investments in less developed countries.

Another exception from the rules which would treat certain foreign source income as "effectively connected" is contained in section 864(c) (4) (C) (ii), which excludes subpart F income. The difficulty here is that there are many exclusions and exceptions to the definition of subpart F income such as:

(1) Dividends, interest, and gains from qualified investments in less developed countries.

(2) Income which would otherwise be subpart F income but which constitutes less than 30 percent of the corporation's gross income.

(3) Income of a corporation not created or organized to reduce taxes.

(4) Royalty income derived in the active conduct of a trade or business which is received from unrelated persons.

The council believes the bill should not extend U.S. income tax to the types of income of a controlled foreign corporation which were carefully considered by the Congress in 1962 and were specifically excluded from the application of subpart F. The exception for subpart F income under section 864(c) (4) should be modified to provide that, for the purposes of that exception, the exclusions from foreign base company income contained in section 954 should not apply.

In view of the policy favoring less developed country corporations contained in subpart F, it is submitted that income received by a less developed country corporation, from the manufacture of personal property abroad and its sale abroad, or from the purchase of personal property from unrelated persons and its sale abroad to unrelated persons should not be considered income subject to the provisions of section 864(c) (4) (B) (iii).

It would appear that the exclusion of all income of controlled foreign corporations would be appropriate since Congress has carefully prescribed just what income of such controlled foreign corporations should be currently taxed. This should not be a precedent for other countries to discriminate against U.S. persons operating in their countries. The provisions regarding controlled foreign corporations operate only to impose additional U.S. income taxes on earnings of U.S. controlled companies.

The National Foreign Trade Council supports the treatment of interest paid on foreign currency and U.S. dollar deposits in foreign branches of U.S. banks as foreign source income as proposed under H.R. 13103, and the elimination of such deposits from the U.S. estate tax base of nonresident aliens. These provisions would tend to place foreign branches of U.S. banks on a competitive basis with foreign banks.

H.R. 13103 indicates that, after December 31, 1971, interest on deposits in domestic offices of U.S. banks, in certain savings and loan associations and in insurance companies, paid to nonresident aliens and foreign corporations will be subject to U.S. income tax whether or not "effectively connected" with a trade or business in the United States. The council believes that the proposed taxation of the interest which is not "effectively connected" with the U.S. trade or business will have an immediate as well as long-range adverse effect on the U.S. balance of payments. The existence of this date in the law will create a psychological barrier to foreign deposits in U.S. banks and will induce a withdrawal of foreign funds from such financial institutions even before the effective date of the tax. Accordingly, the council recommends that this date be deleted from the bill.

Sincerely yours,

ROBERT J. KELLIHER,
Chairman, NFTC Tax Committee.

NATIONAL FOREIGN TRADE COUNCIL, INC.,
New York, N.Y., January 14, 1966.

Re Foreign Investors Tax Act of 1965, H.R. 11297.

Hon. WILBUR D. MILLS,
Chairman, Committee on Ways and Means,
House of Representatives,
Washington, D.C.

DEAR MR. CHAIRMAN: When the Foreign Investors Tax Act of 1965, H.R. 11297, was introduced, it was indicated that comments received would be reviewed by the Ways and Means Committee before the bill is reported to the House in the next session of Congress.

The National Foreign Trade Council had commented on the earlier bill in a letter to you dated July 7, 1965, indicating a general approval of that bill as being in accord with the legislative recommendations of the Fowler task force, which had been appointed to advise on ways in which more U.S. securities could be sold abroad to help meet the balance-of-payments problem. Three recommendations for changes in H.R. 5916 were submitted to you at that time.

The National Foreign Trade Council has reviewed H.R. 11297 from the standpoint of the stated policy of the report of the Fowler task force. The present bill, like the earlier bill, would make important changes in U.S. taxation of foreign investors in U.S. securities which should help to encourage investments in the United States. However, certain other changes made in the later bill would appear to be contrary to the general policies set forth in the report of the Fowler task force. These changes are as follows:

1. The increases in the estate tax rates on nonresident individuals, as compared with those in H.R. 5916, and the inclusion in the taxable estate of bank deposits owned by nonresident alien individuals not engaged in trade or business in the United States, tend to work contrary to the purpose of this legislation.
2. The taxation of interest on bank deposits received after 1970 by nonresident alien individuals and foreign corporations not engaged in trade or business in the United States eliminates from our law a longstanding inducement to the making of such investments in the United States.
3. The proposal to tax nonresident aliens and foreign corporations engaged in trade or business in the United States on income from sources outside of the United States, if it is "effectively connected' with the U.S. trade or business, is a radical extension of the existing scope of our tax law. Its effect would be contrary to the purposes of this bill. It is a major change of policy which the council believes is unwarranted and at least deserves careful and separate consideration. It is in conflict with most treaties with regard to the taxation of U.S. branches of foreign companies, and therefore would be inoperative in those cases.

These matters are discussed in somewhat greater detail in the attached memorandum.

The Fowler task force did not recommend the elimination of U.S. withholding tax on dividends and interest paid to nonresident alien individuals and foreign corporations, apparently because of the expected reduction of revenue and the possible adverse effect on the bargaining power of the United States in treaty negotiations. However, elimination of the tax would be a major incentive to foreign investment in the United States which might well justify the loss of revenue, and the President's power under proposed section 896 to reinstate existing income tax provisions, would preserve the treaty bargaining power. The National Foreign Trade Council therefore suggests that your committee consider the elimination of tax on dividends and interest paid to nonresident aliens and foreign corporations, if such interest is not effectively connected with a trade or business in the United States.

The National Foreign Trade Council believes that the foregoing matters are sufficiently important that hearings should be held on this bill before it is submitted to the House of Representatives in the current session of Congress.

Sincerely yours,

ROBERT J. KELLIHER,
Chairman, Tax Committee.

THE FOREIGN INVESTORS TAX ACT OF 1965

The Foreign Investors Tax Act of 1965, introduced shortly before Congress adjourned, makes three changes which seem to the National Foreign Trade Council to be contrary to the legislation's original intent. This bill, H.R. 11297, grew out of recommendations of the "Fowler task force" for changes in taxation of foreign investors to improve the U.S. balance of payments by stimulating foreign investment in the United States. An earlier version of the proposed legislation, H.R. 5916, wos found to be generally in line with the original recommendations. But the current version, H.R. 11297, proposed changes which, by comparison with the earlier version of the bill or the original recommendations of the Fowler committee, must be viewed as backward steps in three respects: increased estate taxe rates for nonresident alien decedents, and inclusion of certain intangible property presently excluded from their estate tax base; introduction of a novel concept with regard to taxation of nonresident aliens and foreign corporations engaged in trade or business in the United States; and the introduction of income taxation of interest on U.S. bank deposits owned by nonresident aliens and foreign corporations not doing business in the United States.

Recommendations of the Fowler task force

The Presidential task force, appointed to study ways to improve the U.S. balance of payments by stimulating foreign investment, produced many recommendations, including several for changes in U.S. tax laws. Among the tax recommendations were—

(1) "Eliminate U.S. estate taxes on all intangible personal property of nonresident alien decendents."

(2) "Provide that a nonresident alien individual engaged in trade or business within the United States be taxed at regular rates only on income connected with such trade or business." This change would give such persons the benefit of the generally lower rates of U.S. taxation of investment income. (The graduate rates on income over $19,000 were also to be eliminated.)

H.R. 5916

On March 8, 1965, H.R. 5916 was introduced. The National Foreign Trade Council concluded that the bill generally followed the Fowler report recommendations, except that estate tax rates were reduced to a maximum of 15 percent rather than eliminated. The estate tax exemption was increased from $2,000 to $30,000.

In its comments on H.R. 5916, the National Foreign Trade Council recommended that the most desirable change which might be made in that bill would be to return to the original recommendation of the Fowler task force; namely, to eliminate U.S. estate taxes on all intangible personal property of nonresident alien decedents.

Another recommendation made by the Council at that time was to make it clear that nonresident alien individuals who were not engaged in trade or business within the United States should not be required to file income tax returns provided, of course, that their tax had been satisfied by withholding at source. It also recommended that foreign security dealers should be encouraged to participate in the marketing to foreigners of U.S. securities by modifying the definition of the term "engaged in trade or business within the United States." This would permit these dealers to participate in such marketing without being treated as engaged in trade or business in this country.

H.R. 11297

U.S. estate tax

As compared with H.R. 5916, this bill would increase estate tax rates on estates of nonresident aliens to a maximum of 25 percent, thus giving less incentive for foreign investment in the United States than was given by H.R. 5916.

H.R. 11297 would include in the taxable estate of a nonresident alien certain intangible personal property which is excluded from the estate under present law. Such property includes (a) bank deposits of a nonresident alien not engaged in business in the United States, and (b) debt obligations of a U.S. person (including a U.S. corporation), the United States, a State or political subdivision of a State, or the District of Columbia, even though such obligations are physically located abroad. There is no doubt that these provisions will have an adverse effect on foreign investment in the United States.

Interest paid to nonresident aliens and foreign corporations on U.S. bank deposits

Since the Revenue Act of 1921, interest on deposits with persons carrying on the banking business paid to persons not engaged in trade or business within the United States has been treated as foreign source income and consequently not subject to U.S. income tax. In considering the merits of this exclusion from taxable income, the House Ways and Means Committee report (67th Cong., 1st sess.) indicated that "the loss of revenue which would result if this deduction were allowed would be relatively small in amount, while the exemption of such interest from taxation would be in keeping with the action of other countries and would encourage nonresident alien individuals and foreign corporations to transact financial business through institutions located in the United States." H.R. 11297 would completely change this longstanding rule of law in that interest paid on bank deposits to nonresident aliens and foreign corporations after December 31, 1970, will become subject to income tax even though the recipient may not be doing business in the United States. The technical change in source definitions made by the bill affecting bank interest during the interim period 1966 through 1970 is not objectionable since it is not less favorable than existing law in its treatment of U.S. bank interest paid to foreigners.

It is submitted that the factors prevailing in today's economy are even more compelling than in the 1920's in requiring that interest paid on U.S. bank deposits to nonresident alien individuals and foreign corporations not doing business in the United States continue to be exempt from U.S. taxation. The U.S. balance-of-payments problem would be made more acute if this interest were taxed since it seems reasonable to believe that a substantial part of the underlying deposits would be transferred to foreign banks. If this were to happen there would be an increased likelihood of these dollars shifting from private to public hands and then becoming a claim on our gold. In addition, it is evident there would be no gain in U.S. tax revenue but in fact a loss, since the shifting of these deposits to foreign banks not subject to U.S. taxation would reduce taxable income otherwise generated by U.S. banks on these deposits.

H.R. 11297 is intended to encourage foreign investment in the United States by removing tax barriers to such investment, thereby beneficially affecting the U.S. balance of payments. To quote Secretary Fowler in his report to the President of the United States from the task force on promoting increased foreign investment in U.S. corporate securities and increased foreign financing for U.S. corporations operating abroad, "The United States should, however, first attempt to attract foreign investment by attacking the several areas of taxation that deter investment without generating material revenues." The proposed estate tax treatment of U.S. bank deposits and the proposed income taxation of bank interest after 1970 are completely inconsistent with these purposes and will undoubtedly lead to the withdrawal of funds presently employed in our economy.

The NFTC does not object to the proposed treatment of U.S. bank interest paid to nonresident aliens and foreign corporations between January 1, 1966, and December 31, 1970, which in effect continues the exemption which has existed since 1921, and strongly recommends that this treatment be continued in respect of such interest paid after December 31, 1970.

Interest paid to nonresident aliens and foreign corporations on foreign currency deposits with foreign branches of U.S. banks

Under current law, interest on foreign currency deposits with foreign branches of U.S. banks is exempt from U.S. income tax only if the recipient is not doing business in the United States. The proposed bill would categorize such interest as being from foreign sources and thus exempt from U.S. tax if not effectively connected with a U.S. trade or business.

The NFTC agrees with the proposed treatment as foreign source income of interest paid on foreign current deposits with foreign branches of U.S. banks, and strongly urges that interest paid by such branches on U.S. dollar deposits should be accorded the same treatment. Any provision of U.S. tax law which places a foreign branch of a U.S. bank at a competitive disadvantage with a foreign bank can only result ultimately in a loss to the U.S. Treasury and will drive these dollar deposits outside of the U.S. banking system. Transfer of dollar deposits from the U.S. banking system to foreign banks makes them vulnerable to a demand for conversion into gold, as noted above.

New tax concept—"Effectively connected"

One of the recommendations of the Fowler committee was that foreign investors who are engaged in trade or business in the United States should nevertheless be entitled to have their U.S. source investment income taxed at the same rates as persons who were not so engaged. In H.R. 11297, there are provisions to segregate and separately tax investment income and noninvestment income. However, the bill also contains a provision under which the tax on nonresident aliens and foreign corporations will be extended to sources outside the United States if it is "effectively connected" with their U.S. trade or business.

The principle of taxing foreign corporations only on their U.S.-source income is so fundamental in existing law that the proposed change requires many collateral amendments of the code. While the bill makes amendments to the provisions relating to foreign tax credits and dividends-received deductions, these changes are so complex that extended study would be required to determine whether these changes are all that are necessary and to evaluate the importance of the cases in which there may not be complete alleviation of double taxation as a result of the changes.

The introduction of this concept could result in a radical change in the patterns of U.S. taxation of foreign corporations owned by U.S. corporations and individuals. The language which is contained in the proposed revision of the bill could be interpreted to enable the imposition of U.S. income taxes on foreign subsidiaries of U.S. corporations which have relatively minor activities on the part of officers of the foreign subsidiary or officers of the parent corporation on behalf of the subsidiary. Such a change is undesirable and seems unnecessary in light of the major review and overhaul of the taxation of such corporations undertaken in the Revenue Act of 1962.

The introduction of such a novel concept as taxing foreign persons on their income from sources without the United States seems inappropriate in this legislation because it is not connected with the primary purpose of the bill.

Approximately three-quarters of our income tax treaties provide that where a foreign corporation has a permanent establishment in the United States such permanent establishment is subject to tax only on its U.S. source income attributable to the permanent establishment.

The term "effectively connected" is not defined in the bill, but instead, proposed section 864(c) merely cites three factors which should be taken into account in determining whether gains, profits and income, or loss shall be treated as "effectively connected" with the conduct of a trade or business within the United States.

It is considered that the lack of a clear definition of "effectively connected" would tend to discourage U.S. investment. Nonresident aliens and foreign corporations in trade or business in the United States could not be sure whether they would be entitled to the investment rate of U.S. taxation on their U.S. investment income or whether their foreign source income would also become subject to U.S. tax.

RECOMMENDATIONS

1. As to estate taxation of nonresident aliens, it is recommended that the initial suggestion of the Fowler task force with regard to elimination of U.S. estate taxes on intangible personal property of nonresident alien decedents be followed.

2. It is recommended that interest paid on deposits in foreign branches of U.S. banks be treated as foreign source income. This treatment is proposed in H.R. 11297 for foreign currency deposits; it should be extended to include dollar deposits.

3. As to income taxation of interest paid on bank deposits in the United States to nonresident aliens and foreign corporations not doing business in the United States, it is recommended that the treatment proposed in H.R. 11297 for the period 1966 through 1970, which in effect continues the present exemption which has existed since 1921, be continued after 1970.

4. As to the taxation of nonresident aliens and foreign corporations engaged in trade or business in the United States, it is recommended that such persons be taxed only on their U.S. source income. It is further recommended that the term "effectively connected" be defined so as to eliminate the problems discussed above.

5. Because of the importance of the above described changes in the U.S. tax law proposed by H.R. 11297, it is urged that hearings be held by the Ways and Means Committee to consider the full implications of the proposals.

STATEMENT OF NEW YORK COUNTY LAWYERS ASSOCIATION, SPECIAL SUBCOMMITTEE OF THE COMMITTEE ON TAXATION, JAY O. KRAMER; WALLACE S. JONES; AND CARTER T. LOUTHAN, CHAIRMAN

REPORT OF H.R. 13103, THE FOREIGN INVESTORS TAX ACT OF 1966

(Due to the shortness of available time this report was not considered by the committee on taxation)

Summary of Report on H.R. 13103

H.R. 13103 removes our prior objections to the estate tax treatment of bank accounts and the income and estate tax treatment of dollar deposits with foreign branches of U.S. banks.

H.R. 13103 does not meet our objections to the estate tax treatment of bonds issued by U.S. persons. The situs rules for estate and gift tax purposes should be consistent.

The provisions of H.R. 13103 with respect to income effectively connected with the conduct of a business in the United States by a nonresident alien are preferable to those of H.R. 11297, but do not meet our objection that the tests are so vague that the resultant uncertainty will discourage foreign investments in the United States. It is arbitrary and unfair to require that all income from sources within the United States, other than that subject to tax at the flat rate, be deemed to be effectively connected with the conduct of a business in the United States.

A technical amendment is necessary in section 2(d) of H.R. 13103, relating to the exclusion of dividends and interest from foreign subsidiaries from income effectively connected wih the conduct of a business in the United States.

1. Bank accounts and bonds

The present estate tax law provides that deposits with persons engaged in the banking business are not includible in the taxable gross estate of a nonresident alien not engaged in business in the United States. Under present law, bonds issued by U.S. persons are includible in the taxable gross estate of nonresident aliens only if the bond itself is physically located in the United States on the taxable date.

Section 8 of H.R. 11297 would have repealed this estate tax exemption as to deposits and would have provided that bonds issued by U.S. persons should be includible in the taxable estate of nonresident alien decedents even though not physically located in the United States on the taxable date.

71-297 O-67-pt. 1—37

Our prior report on H.R. 11297 objected to these proposals on the ground that they probably would induce nonresident aliens to withdraw their deposits and to dispose of bonds issued by U.S. persons.

Section 8 of H.R. 13103 relieves, for the time being, the problem as to deposits by continuing their exemption through December 31, 1971.

Section 8(c) of H.R. 13103 ameliorates to some extent the rule with respect to bonds issued by U.S. corporations. However, exemption is granted as to such bonds only if the obligor derived less than 20 percent of its gross income from sources within the United States for the 3-year period ending with the close of its taxable year ending prior to the nonresident alien's death. This exemption will apply to only a small fraction of the bonds now held by nonresident aliens. In view of the sensitivity of nonresident aliens to estate tax, it seems probable that a substantial portion of the U.S. bonds owned by them will be liquidated. We again question whether such a provision is desirable at this time when we are seeking to improve our balance of payments.

Sections 8(c) and 9(b), respectively setting forth the situs rules as to debt obligations for estate and gift tax purposes, are not the same. As a matter of consistency we recommend that the same situs rules be incorporated in both sections.

2. Dollar deposits with foreign branches of U.S. banks

The amendments made by sections 2 and 8 of H.R. 13103 will exempt nonresident aliens from income tax on interest on dollar deposits made by nonresident aliens with a foreign branch of a domestic bank and also will exempt such deposits from estate tax. These amendments meet the objections made in our prior report on H.R. 11297.

3. Income effectively connected with the conduct of a trade or business

Although section 2(d) of H.R. 13103 revises considerably the statutory provisions with respect to the effectively connected concept, there still is no definition of the term and the inherent vagueness which we criticized in our prior report, still persists.

Section 864(c)(2), as added by section 2(d) of H.R. 13103, eliminates, as an independent factor in determining whether income is effectively connected with the conduct of a business in the United States, the question of how the item is accounted for. However, the manner in which the item is accounted for still is to be considered in determining the applicability of the two statutory factors. This is preferable to the prior approach, but it still appears to be subject to the same basic objection we raised in our report on H.R. 11297, viz that it may trap the unsophisticated and be subject to manipulation by the sophisticated.

Section 864(c)(2), as added by section 2(d) of H.R. 13103, requires that a determination be made as to whether the fixed or determinable annual or periodical income subject to the 30 percent flat rate of tax is, or is not, effectively connected with the conduct of a trade or business.

On the other hand, section 864(c)(3), as added by section 2(d) of H.R. 13103, requires that all other income from sources within the United States be deemed to be effectively connected with the conduct of any trade or business carried on by the nonresident alien taxpayer. That this broadside approach does not produce fair results in all cases is shown by the following examples:

Assume in each case that the nonresident alien taxpayer is a partner in a firm engaged in manufacturing in the United States.

1. The taxpayer purchased a life insurance policy upon the life of X, and on X's death collected the insurance proceeds. Section 101(a)(2) is applicable and the gain is taxable. Such income has no connection whatsoever with the manufacturing business, but under section 864(c)(3) is deemed to be effectively connected with such business so as to be subject to tax at graduated rates.

2. The taxpayer owned a painting which cost him $50,000 and is now worth $200,000. He ships the painting from the United States to Europe and insures it for $200,000. The ship sinks, the painting is lost and the taxpayer collects the full insurance. Under Revenue Ruling 60–278, 1960–2 C.B. 214, the resulting profit is deemed to be from sources within the United States. Although the profit has no connection with the business, it is deemed to be effectively connected with it and is subject to tax at graduated rates.

3. The nonresident alien taxpayer formerly resided in the United States, and while here purchased a home. The property is subject to a $75,000 mortgage.

The taxpayer got into financial difficulties and negotiated a settlement under which he paid off the mortgage at 50 cents on the dollar. The income arising from this transaction, although having no business connection, is deemed to be effectively connected with the business so as to be subject to tax at graduated rates.

Since it is arbitrary and contrary to fact to treat income arising in transactions such as these as being effectively connected with the business carried on by the taxpayer, it is assumed that Congress would not desire to so classify it. It is recommended that section 864(c)(3), as added by section 2(d) of H.R. 13103, be amended by striking out the period at the end and adding a comma and the following: "unless the taxpayer affirmatively establishes to the contrary by the preponderance of the evidence."

Section 864(c)(4) as added by section 2(d) of H.R. 13103 relates to the taxation of income from sources without the United States if it is effectively connected with the conduct of a business in the United States. We believe the limitation placed upon the effectively connected concept by this provision will be helpful in avoiding some of the problems which otherwise would arise.

Section 864(c)(4)(C) provides that no income or loss from sources without the United States shall be treated as effectively connected with the conduct of a business in the United States if it consists either—

(i) Of dividends, interest, or royalties paid by a foreign corporation in which the taxpayer owns or is deemed to own under section 958(a) or 958(b), more than 50 percent of the total voting power; or

(ii) Is subpart F income.

The provisions of section 864(c)(4)(C)(i) appear to have been taken from section 957(a) of the Code for the purpose of incorporating the operating rules of sections 958(a) and 958(b). However, section 958(a) is applicable only for the purpose of subpart F and section 958(b) is applicable only for the purpose of certain specified sections of subpart F, all of which relate to the taxation of U.S. shareholders.

In order to secure the desired result, it seems necessary to amend section 864(c)(4)(C)(i) to insert immediately after the word "taxpayer" (line 15, p. 16), the following: "(considered for this purpose as a U.S. shareholder)".

THE PROPRIETARY ASSOCIATION,
Washington, D.C., March 2, 1966.

Re H.R. 11297.

Hon. WILBUR D. MILLS,
Chairman, House Ways and Means Committee,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: On February 21, 1966, this association submitted a letter requesting that public hearings be held on H.R. 11297. In recognition of the protests of this association and similar groups, revisions to the bill were published on March 1, 1966, and hearings on these revisions are scheduled for March 7, 1966.

While the association considers the amending of this bill and the holding of public hearings to be a favorable step toward the elimination of the problems which we envisioned, we are nevertheless concerned with some of the novel concepts still retained in the bill as revised. Unfortunately, we are unable to submit a detailed statement or make proper testimony in this regard because of the limited time available to canvass our association members and develop specific comments on these revised sections.

The tax committee of our association advises that the major concerns of the members of our Association will be relieved if section 882(c)(4)(C) is amended to read as follows:

"No income, gain, or loss from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States if it is derived by a foreign corporation which is more than 50-percent owned, directly or indirectly, by U.S. persons."

Very truly yours,

ARTHUR J. KIRIACON,
Chairman, Tax Committee.

ROOT, BARRETT, COHEN, KNAPP & SMITH,
New York, N.Y., March 4, 1966.

Re H.R. 13103.

LEO H. IRWIN, Esq.,
Chief Counsel, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR SIR: An announcement by the chairman of the Committee on Ways and Means, dated February 24, 1966, stated that a public hearing would be held on Monday, March 7, 1966, on the new features of a revised version of H.R. 11297, which have since been introduced in the form of a new bill, H.R. 13103. In accordance with the suggestion contained in the announcement with respect to submission of written statements, this letter is being submitted by the undersigned, as a member of the New York bar, in lieu of a personal appearance.

I wish to draw your attention to what appears to be a technical drafting problem with respect to the possible retroactive application—which may have been unintended—of section 2(d) of H.R. 13103, dealing with the definition of those cases in which income from sources without the United States shall be treated as being "effectively connected with the conduct of a trade or business within the United States."

Under the new proposed section 864(c)(4)(B)(iii) (at p. 15 of the committee print, lines 18–24, and p. 16, lines 1–2) income derived by a foreign corporation from sources without the United States would be subject to tax if the foreign corporation has an office within the United States to which such income is attributable and such income is derived from one of three listed categories. The third category is income derived from sales of inventory which were made without the United States but through the U.S. office, with the exception of sales for use outside the United States in which an office outside the United States participated materially.

This new test for sales made outside the United States constitutes a sharp departure from existing law, under which a foreign corporation is not taxed on income from the sale of goods without the United States, whether or not such sale was handled through an office or fixed place of business within the United States.

Of particular concern is the possibility that the new test could have retroactive application. Under section 2(e) of the bill, these new provisions are effective with respect to taxable years beginning after December 31, 1966. However, if a long-term contract of sale were concluded by the U.S. office of a foreign corporation prior to the effective date of the act, and foreign source income from shipments made pursuant to that preexisting long-term contract is then received or accrued in taxable years after the effective date of the act, the new subsection might impose a tax on the foreign source income merely because a U.S. office was originally used to make the contract.

It should be noted that long term contracts of sale are frequently employed in international trade, particularly in regard to bulk shipments of oil, minerals, and the like. With respect to these, the possible retroactive application of section 2(e) could have serious adverse effects if the foreign corporation utilized a U.S. office for handling foreign sales, at a time when such utilization was wholly permissible under the law then in effect.

Since it appears likely that such retroactive application of the new test is not intended, it is suggested that the language of the new proposed section 864(c)(4)(B)(iii) (supra) be changed by adding the italicized language:

"(iii) is derived from the sale (without the United States) through such office or fixed place of business, *after December 31, 1966*, of personal property described in section 1221(1), except that this clause shall not apply if the property is sold for use, consumption, or disposition outside the United States and *either* an office or other fixed place of business of the taxpayer outside the United States participated materially in such sale *or the agreement pursuant to which such sale was made was executed prior to March 1, 1966.*"

Sincerely yours,

DAVID SIMON.

SOCONY MOBIL OIL CO., INC.,
New York, N.Y., March 4, 1966.

Re Foreign Investors Tax Act.

Hon WILBUR D. MILLS,
Chairman, Committee on Ways and Means, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: On January 28, 1966, I wrote to you to express concern over certain provisions of the Foreign Investors Tax Act, H.R. 11297. I have since had the chance to review the refinements in this proposal which are contained in the new bill, H.R. 13103. In accordance with your request, I will confine my comments here to those refinements.

The changes which were made with regard to the "effectively connected" principle represent a substantial improvement since it is now applicable to foreign source income only in those situations which are set out in the new bill. The exemption of subpart F income from the foreign source income taxable under this principle is likewise a substantial improvement, largely obviating the risk of unintended taxation of the foreign subsidiaries of U.S. corporations under H.R. 13103. It would be still better if the exemption provided that the subpart F income exclusions and exceptions contained in section 954 should not apply for purpose of determining the foreign source income exempt from the "effectively connected principle". Since Congress intended these subpart F exclusions and exceptions to be of benefit to the taxpayer, it would be well to be sure that they would not operate under this new bill to impose additional taxes.

While the criteria for income which is "effectively connected" are still somewhat unclear, this is no longer so important because the scope of the "effectively connected" principle has been reduced. However, in order to attract the maximum investment by foreign persons engaged in trade or business here, your committee reports should endeavor to make clear under what circumstances U.S. investments by such persons will not be considered to be "effectively connected". Otherwise, uncertainty may prevent such persons from making the kind of U.S. investments which the Fowler task force was so anxious to encourage.

Some improvement has been made in the provisions relating to taxation of bank deposits. I personally still feel that the further amendments recommended in my letter to you would also tend toward improving the U.S. balance of payments. However, I realize that you must balance various considerations in determining how far you should go in attempting to encourage or retain investment by foreign persons in the United States. The cooperation of your committee and staff, and of Treasury staff, in meeting taxpayers' major objections to H.R. 11297 is greatly appreciated.

Respectfully yours,

GEORGE F. JAMES,
Senior Vice President.

MARCH 3, 1966.

Re Foreign Investors Tax Act of 1966, H.R. 13103.

Hon. WILBUR D. MILLS,
Chairman, Committee on Ways and Means,
House of Representatives,
Washington, D.C.

DEAR MR. CHAIRMAN: The undersigned, who appeared at the public hearings on H.R. 5916, are gratified that section 2(a)(1)(B) of the present bill gives life insurance companies the same exemption as that granted to banks and savings and loan associations on interest payments made on funds held on deposit under a contract to pay interest. For the reasons we have already stated to your committee, we believe that the extension of the interest exemption to life insurance companies can only further the avowed purposes of the bill.

We must record, however, our strong opposition to the provision of section 2(a)(1)(B) of the present bill which would cut off all such interest exemptions on December 31, 1971. We believe that all of the reasons previously advanced in support of the interest exemption argue for its indefinite continuance. The effect upon the maintenance here and the future inflow of such foreign deposits. position by forcing the withdrawal from this country of deposits held by nonresident aliens and foreign corporations not doing business here, and effectively preventing future deposits from such sources. In this connection we fully endorse and support the able statement of the National Foreign Trade Council, Inc., in its letters to you of January 14, 1966, and February 4, 1966.

We believe that even incorporating in the code at this time notice of an automatic cutoff of the exemption in 1971 will have an immediately discouraging effect upon the maintenance here and the future inflow of such foreign deposits. Such a provision now also seems quite unnecessary, since Congress can end the exemption at any time in the future when it considers that our national economic circumstances make it desirable to do so. We respectfully suggest that that time has not come and is unlikely to come in the foreseeable future.

Sincerely yours,

THE UNITED STATES LIFE INSURANCE CO. IN THE CITY OF NEW YORK,
By SAUL LESSER,
Associate General Counsel.

AMERICAN LIFE INSURANCE CO.,
By GORDON B. TWEEDY.
Chairman of the Board.

SECTION 15

PRESS RELEASE OF THE COMMITTEE ON WAYS AND MEANS DATED MARCH 17, 1966, ANNOUNCING THAT THE COMMITTEE ORDERED FAVORABLY REPORTED TO THE HOUSE, WITH AMENDMENTS, H.R. 13103, THE "FOREIGN INVESTORS TAX ACT OF 1966"

FOR IMMEDIATE RELEASE
MARCH 17, 1966

COMMITTEE ON WAYS AND MEANS
U. S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.

Chairman Wilbur D. Mills (D., Ark.), Committee on Ways and Means, today announced that the Committee has ordered favorably reported to the House, with amendments, H. R. 13103, the "Foreign Investors Tax Act of 1966".

A brief summary of the amendments in the bill as it will be reported is set forth below:

1. Foreign Life Insurance Companies.--The definition of income effectively connected with the life insurance business of a foreign life insurance company was extended to include income from sources without the United States which is attributable to its U. S. business. This, in effect, continues the treatment which applies under the present regulations.

2. Effective Date of Foreign Source Sales Income.--Sales income from sources without the United States pursuant to binding contracts entered into on or before February 24, 1966, are not to be subject to the "effectively connected" rules to the extent of the negotiations occurring under such a contract before this date.

3. Foreign Tax Credit Limitation for Interest Income.--The provisions of the Code (sec. 904(f)), which require the use of the "per country" limitation, separately, in certain cases involving interest income, were modified. An exception in present law is provided for interest income received from a corporation in which the taxpayer owns at least 10 percent of the voting stock. This was extended by the Committee's action to interest received from a foreign corporation of the same affiliated group provided the taxpayer was formed and availed of for purposes of (1) borrowing abroad in the public market; and (2) using these funds to finance the foreign operation of related corporations.

4. Foreign Community Property Income of U. S. Citizen.--Under present law, U. S. citizens who reside abroad in a foreign country which has community property laws have been held to be subject to U. S. tax on one-half of the marital community income. As a result, where a U. S. citizen is a spouse of a foreigner and resides in a community property country, half of the income earned by the foreigner or derived from property of the foreigner is considered to be income of the U. S. spouse and subject to U. S. tax. The Committee amendment, in effect, permits taxpayers in such cases to elect out of the operation of the community property laws of foreign countries.

Legislative language implementing these amendments will not be available until the bill has been reported to the House. The Committee report will be filed in due course.

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SECTION 16

BILL AS REPORTED BY THE COMMITTEE ON WAYS AND MEANS

Union Calendar No. 631

89TH CONGRESS
2D SESSION

H. R. 13103

[Report No. 1450]

IN THE HOUSE OF REPRESENTATIVES

FEBRUARY 28, 1966

Mr. MILLS introduced the following bill; which was referred to the Committee on Ways and Means

APRIL 26, 1966

Reported with amendments, committed to the Committee of the Whole House on the State of the Union, and ordered to be printed

[Omit the part struck through and insert the part printed in italic]

A BILL

To amend the Internal Revenue Code of 1954 to provide equitable tax treatment for foreign investment in the United States.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE, ETC.

(a) SHORT TITLE.—This Act may be cited as the "Foreign Investors Tax Act of 1966".

(b) TABLE OF CONTENTS.—

SEC. 4. Foreign corporations—Continued
(b) Tax on income connected with United States business:
"SEC. 882. Income of foreign corporations connected with United States business.
"(a) Normal tax and surtax.
"(b) Gross income.
"(c) Allowance of deductions and credits.
"(d) Election to treat real property income as income connected with United States business.
"(e) Returns of tax by agent.
"(f) Foreign corporations."
(c) Withholding of tax on foreign corporations.
(d) Dividends received from certain foreign corporations.
(e) Unrelated business taxable income.
(f) Corporations subject to personal holding company tax.
(g) Amendments with respect to foreign corporations carrying on insurance business in United States.
(h) Subpart F income.
(i) Gain from certain sales or exchanges of stock in certain foreign corporations.
(j) Declaration of estimated income tax by corporations.
(k) Technical amendments.
(l) Effective dates.
SEC. 5. Special tax provisions.
(a) Income affected by treaty.
(b) Application of pre-1967 income tax provisions:
"SEC. 896. Application of pre-1967 income tax provisions.
"(a) Imposition of more burdensome taxes by foreign country.
"(b) Alleviation of more burdensome taxes.
"(c) Notification of Congress required.
"(d) Implementation by regulations."
(c) Clerical amendments.
(d) Effective date.
SEC. 6. Foreign tax credit.
(a) Allowance of credit to certain nonresident aliens and foreign corporations.
(b) Alien residents of the United States or Puerto Rico.
SEC. 7. Amendment to preserve existing law on deductions under section 931.
(a) Deductions.
(b) Effective date.
SEC. 8. Estates of nonresidents not citizens.
(a) Rate of tax.
(b) Credits against tax.
(c) Property within the United States.
(d) Property without the United States.
(e) Definition of taxable estate.

(c) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference is to a section or other provision of the Internal Revenue Code of 1954.

SEC. 2. SOURCE OF INCOME.

(a) INTEREST.—

(1) (A) Subparagraph (A) of section 861 (a) (1) (relating to interest from sources within the United States) is amended to read as follows:

"(A) interest on amounts described in subsection (c) received by a nonresident alien individual or a foreign corporation, if such interest is not effectively connected with the conduct of a trade or business within the United States,".

(B) Section 861 is amended by adding at the end thereof the following new subsection:

"(c) INTEREST ON DEPOSITS, ETC.—For purposes of subsection (a) (1) (A), the amounts described in this subsection are—

"(1) deposits with persons carrying on the banking business,

"(2) deposits or withdrawable accounts with savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law, but only to the extent that amounts paid or credited on such deposits or accounts are deductible under section 591 in computing the taxable income of such institutions, and

"(3) amounts held by an insurance company under an agreement to pay interest thereon.

Effective with respect to amounts paid or credited after December 31, 1971, subsection (a) (1) (A) and this subsection shall cease to apply."

(2) Section 861 (a) (1) is amended by striking out "and" at the end of subparagraph (B), by striking out the period at the end of subparagraph (C) and inserting

in lieu thereof ", and", and by adding at the end thereof the following new subparagraph:

"(D) interest on deposits with a foreign branch of a domestic corporation, if such branch is engaged in the commercial banking business."

(3) (A) Section 895 (relating to income derived by a foreign central bank of issue from obligations of the United States) is amended—

(i) by striking out "shall not be included" and inserting in lieu thereof ", or from interest on deposits with persons carrying on the banking business, shall not be included";

(ii) by striking out "such obligations" and inserting in lieu thereof "such obligations or deposits";

(iii) by adding at the end thereof the following new sentence: "For purposes of the preceding sentence, the Bank for International Settlements shall be treated as a foreign central bank of issue with respect to interest on deposits with persons carrying on the banking business."; and

(iv) by striking out the heading and inserting in lieu thereof the following:

"SEC. 895. INCOME DERIVED BY A FOREIGN CENTRAL BANK OF ISSUE FROM OBLIGATIONS OF THE UNITED STATES OR FROM BANK DEPOSITS."

(B) The table of sections for subpart C of part II of subchapter N of chapter 1 is amended by striking out the item relating to section 895 and inserting in lieu thereof the following:

"Sec. 895. Income derived by a foreign central bank of issue from obligations of the United States or from bank deposits."

(b) DIVIDENDS.—

(1) Section 861 (a) (2) (B) (relating to dividends from sources within the United States) is amended to read as follows:

"(B) from a foreign corporation unless less than 80 percent of the gross income from all sources of such foreign corporation for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was effectively connected with the conduct of a trade or business within the United States; but only in an amount which bears the same ratio to such dividends as the gross income of the corporation for such period which is effectively connected with the conduct of a trade or business within the United States bears to its gross income from all sources; but dividends from a foreign corporation shall, for purposes of subpart A of part III (relating to foreign tax credit), be treated as income from sources without the United States to the extent (and only to the extent) exceeding the amount which is 100/85ths of the amount of the deduction allowable under section 245 in respect of such dividends, or".

(2) Section 861 (a) (2) is amended by adding after subparagraph (C) the following:

"For purposes of subparagraph (B), the gross income of the foreign corporation for any period before the first taxable year beginning after December 31, 1966, which is effectively connected with the conduct of a trade or business within the United States is an amount equal to the gross income for such period from sources within the United States."

(c) PERSONAL SERVICES.—Section 861 (a) (3) (C)

(ii) (relating to income from personal services) is amended to read as follows:

"(ii) an individual who is a citizen or resident of the United States, a domestic partnership, or a domestic corporation, if such labor or services are performed for an office or place of business maintained in a foreign country or in a possession of the United States by such individual, partnership, or corporation."

(d) DEFINITIONS.—Section 864 (relating to definitions) is amended—

(1) by striking out "For purposes of this part," and inserting in lieu thereof

"(a) SALE, ETC.—For purposes of this part,"; and

(2) by adding at the end thereof the following new subsections:

"(b) TRADE OR BUSINESS WITHIN THE UNITED STATES.—For purposes of this part, part II, and chapter 3, the term 'trade or business within the United States' includes the performance of personal services within the United States at any time within the taxable year, but does not include—

"(1) PERFORMANCE OF PERSONAL SERVICES FOR

FOREIGN EMPLOYER.—The performance of personal services—

"(A) for a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, or

"(B) for an office or place of business maintained in a foreign country or in a possession of the United States by an individual who is a citizen or resident of the United States or by a domestic partnership or a domestic corporation,

by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year and whose compensation for such services does not exceed in the aggregate $3,000.

"(2) TRADING IN SECURITIES OR COMMODITIES.—

"(A) STOCKS AND SECURITIES.—

"(i) Except in the case of a dealer in stocks or securities, trading in stocks or securities for the taxpayer's own account, whether by the taxpayer or his employees or through a resident broker, commission agent, custodian, or other agent, and whether or not any such agent has discretionary authority to make decisions in effecting the transactions. This clause shall not apply in the case of a corporation (other than a corporation which is, or but for section 542 (c) (7) would be, a personal holding company) the principal business of which is trading in stocks or securities for its own account, if its principal office is in the United States.

"(ii) In the case of a person who is a dealer in stocks or securities, trading in stocks or securities for his own account through a resident broker, commission agent, custodian, or other independent agent.

"(B) COMMODITIES.—

"(i) Except in the case of a dealer in commodities, trading in commodities for the taxpayer's own account, whether by the taxpayer or his employees or through a resident broker, commission agent, custodian, or other agent, and whether or not any such agent has discretionary authority to make decisions in effecting the transactions.

"(ii) In the case of a person who is a dealer in commodities, trading in commodities for his own account through a resident broker, commission agent, custodian, or other independent agent.

"(iii) Clauses (i) and (ii) apply only if the commodities are of a kind customarily dealt in on an organized commodity exchange and if the transaction is of a kind customarily consummated at such place.

"(C) LIMITATION.—Subparagraphs (A) (ii) and (B) (ii) shall apply only if, at no time during the taxable year, the taxpayer has an office or place of business in the United States through which or by the direction of which the transactions in stocks or securities, or in commodities, as the case may be, are effected.

"(c) EFFECTIVELY CONNECTED INCOME, ETC.—

"(1) GENERAL RULE.—For purposes of this title—

"(A) In the case of a nonresident alien individual or a foreign corporation engaged in trade or business within the United States during the taxable year, the rules set forth in paragraphs (2), (3), and (4) shall apply in determining the income, gain, or loss which shall be treated as effectively connected with the conduct of a trade or business within the United States.

"(B) Except as provided in section 871 (d) or