

1 section 882 (d), in the case of a nonresident alien
2 individual or a foreign corporation not engaged in
3 trade or business within the United States during the
4 taxable year, no income, gain, or loss shall be treated
5 as effectively connected with the conduct of a trade
6 or business within the United States.

7 “(2) PERIODICAL, ETC., INCOME FROM SOURCES
8 WITHIN UNITED STATES—FACTORS.—In determining
9 whether income from sources within the United States
10 of the types described in section 871 (a) (1) or section
11 881 (a), or whether gain or loss from sources within
12 the United States from the sale or exchange of capital
13 assets, is effectively connected with the conduct of a
14 trade or business within the United States, the factors
15 taken into account shall include whether—

16 “(A) the income, gain, or loss is derived from
17 assets used in or held for use in the conduct of such
18 trade or business, or

19 “(B) the activities of such trade or business
20 were a material factor in the realization of the in-
21 come, gain, or loss.

22 In determining whether an asset is used in or held for
23 use in the conduct of such trade or business or whether
24 the activities of such trade or business were a material
25 factor in realizing an item of income, gain, or loss, due

1 regard shall be given to whether or not such asset or
 2 such income, gain, or loss was accounted for through
 3 such trade or business. In applying this paragraph and
 4 paragraph (4), interest referred to in section 861 (a)
 5 (1) (A) shall be considered income from sources within
 6 the United States.

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

13 “(4) INCOME FROM SOURCES WITHOUT UNITED
 14 STATES.—

15 “(A) Except as provided in subparagraph
 16 ~~(B)~~, (B) and (C), no income, gain, or loss from
 17 sources without the United States shall be treated
 18 as effectively connected with the conduct of a trade
 19 or business within the United States.

20 “(B) Income, gain, or loss from sources with-
 21 out the United States shall be treated as effectively
 22 connected with the conduct of a trade or business
 23 within the United States by a nonresident alien
 24 individual or a foreign corporation if such person

1 has an office or other fixed place of business within
2 the United States to which such income, gain, or
3 loss is attributable and such income, gain, or loss—

4 “(i) consists of rents or royalties for the
5 use of or for the privilege of using intangible
6 property described in section 862(a)(4) (in-
7 cluding any gain or loss realized on the sale of
8 such property) derived in the active conduct
9 of such trade or business;

10 “(ii) consists of dividends or interest, or
11 gain or loss from the sale or exchange of stock
12 or notes, bonds, or other evidences of indebted-
13 ness, and either is derived in the active conduct
14 of a banking, financing, or similar business
15 within the United States or is received by a
16 corporation the principal business of which is
17 trading in stock or securities for its own account;
18 or

19 “(iii) is derived from the sale (without
20 the United States) through such office or fixed
21 place of business of personal property described
22 in section 1221(1), except that this clause
23 shall not apply if the property is sold for use,

1 consumption, or disposition outside the United
 2 States and an office or other fixed place of busi-
 3 ness of the taxpayer outside the United States
 4 participated materially in such sale.

5 In the case of a sale described in clause (iii), the
 6 income which shall be treated as attributable to the
 7 office or other fixed place of business within the
 8 United States shall not exceed the income which
 9 would be derived from sources within the United
 10 States if the sale were made in the United States.

11 “(C) *In the case of a foreign corporation tax-*
 12 *able under part I of subchapter L, any income from*
 13 *sources without the United States which is attrib-*
 14 *utable to its United States business shall be treated*
 15 *as effectively connected with the conduct of a trade*
 16 *or business within the United States.*

17 “~~(C)~~ (D) No income, gain, or loss from sources
 18 without the United States shall be treated as effec-
 19 tively connected with the conduct of a trade or
 20 business within the United States if it either—

21 “(i) consists of dividends, interest, or
 22 royalties paid by a foreign corporation in which
 23 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 mean-
 ing 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; *except that in*
applying section 864(c)(4)(B)(iii) of the Internal
Revenue Code of 1954 (as added by subsection (d))
with respect to a binding contract entered into on or
before February 24, 1966, activities in the United
States on or before such date in negotiating or carrying
out such contract shall not be taken into account.

(2) The amendments made by subsection (b)
 shall apply with respect to amounts received after De-
 cember 31, 1966.

SEC. 3. NONRESIDENT ALIEN INDIVIDUALS.

(a) TAX ON NONRESIDENT ALIEN INDIVIDUALS.—

1 (1) Section 871 (relating to tax on nonresident
2 alien individuals) is amended to read as follows:

3 **"SEC. 871. TAX ON NONRESIDENT ALIEN INDIVIDUALS.**

4 **"(a) INCOME NOT CONNECTED WITH UNITED STATES**
5 **BUSINESS—30 PERCENT TAX.—**

6 **"(1) INCOME OTHER THAN CAPITAL GAINS.—**There
7 is hereby imposed for each taxable year a tax of 30 per-
8 cent of the amount received from sources within the
9 United States by a nonresident alien individual as—

10 **"(A)** interest, dividends, rents, salaries, wages,
11 premiums, annuities, compensations, remunerations,
12 emoluments, and other fixed or determinable an-
13 nual or periodical gains, profits, and income,

14 **"(B)** gains described in section 402 (a) (2),
15 403 (a) (2), or 631 (b) or (c), and gains on
16 transfers described in section 1235, and

17 **"(C)** amounts which under section 341, or
18 under section 1232 (in the case of bonds or other
19 evidences of indebtedness issued after September 28,
20 1965), are treated as gains from the sale or ex-
21 change of property which is not a capital asset,
22 but only to the extent the amount so received is not effec-
23 tively connected with the conduct of a trade or business
24 within the United States.

25 **"(2) CAPITAL GAINS OF ALIENS PRESENT IN THE**

1 UNITED STATES 183 DAYS OR MORE.—In the case of a
2 nonresident alien individual present in the United States
3 for a period or periods aggregating 183 days or more
4 during the taxable year, there is hereby imposed for such
5 year a tax of 30 percent of the amount by which his
6 gains, derived from sources within the United States,
7 from the sale or exchange at any time during such year
8 of capital assets exceed his losses, allocable to sources
9 within the United States, from the sale or exchange at
10 any time during such year of capital assets. For pur-
11 poses of this paragraph, gains and losses shall be taken
12 into account only if, and to the extent that, they would
13 be recognized and taken into account if such gains and
14 losses were effectively connected with the conduct of a
15 trade or business within the United States, except that
16 such gains and losses shall be determined without regard
17 to section 1202 (relating to deduction for capital gains)
18 and such losses shall be determined without the benefits
19 of the capital loss carryover provided in section 1212.
20 Any gain or loss which is taken into account in deter-
21 mining the tax under paragraph (1) or subsection (b)
22 shall not be taken into account in determining the tax
23 under this paragraph. For purposes of the 183-day re-
24 quirement of this paragraph, a nonresident alien individ-
25 ual not engaged in trade or business within the United

1 States who has not established a taxable year for any
 2 prior period shall be treated as having a taxable year
 3 which is the calendar year.

4 “(b) INCOME CONNECTED WITH UNITED STATES
 5 BUSINESS—GRADUATED RATE OF TAX.—

6 “(1) IMPOSITION OF TAX.—A nonresident alien
 7 individual engaged in trade or business within the
 8 United States during the ~~taxable~~ taxable year shall be tax-
 9 able as provided in section 1 or 1201 (b) on his taxable
 10 income which is effectively connected with the conduct
 11 of a trade or business within the United States.

12 “(2) DETERMINATION OF TAXABLE INCOME.—In
 13 determining taxable income for purposes of paragraph
 14 (1), gross income includes only gross income which is
 15 effectively connected with the conduct of a trade or
 16 business within the United States.

17 “(c) PARTICIPANTS IN CERTAIN EXCHANGE OR
 18 TRAINING PROGRAMS.—For purposes of this section, a non-
 19 resident alien individual who (without regard to this sub-
 20 section) is not engaged in trade or business within the
 21 United States and who is temporarily present in the United
 22 States as a nonimmigrant under subparagraph (F) or (J)
 23 of section 101 (a) (15) of the Immigration and Nationality

1 Act, as amended (8 U.S.C. 1101 (a) (15) (F) or (J)),
 2 shall be treated as a nonresident alien individual engaged in
 3 trade or business within the United States, and any income
 4 described in section 1441 (b) (1) or (2) which is received
 5 by such individual shall, to the extent derived from sources
 6 within the United States, be treated as effectively connected
 7 with the conduct of a trade or business within the United
 8 States.

9 “(d) ELECTION TO TREAT REAL PROPERTY INCOME
 10 AS INCOME CONNECTED WITH UNITED STATES BUSI-
 11 NESS.—

12 “(1) IN GENERAL.—A nonresident alien individ-
 13 ual who during the taxable year derives any income—

14 “(A) from real property *held for the produc-*
 15 *tion of income and* located in the United States,
 16 or from any interest in such real property, in-
 17 cluding (1) gains from the sale or exchange of *such*
 18 real property. or an interest therein, (ii) rents or
 19 royalties from mines, wells, or other natural deposits,
 20 and (iii) gains described in section 631 (b) or (c),
 21 and

22 “(B) which, but for this subsection, would not
 23 be treated as income which is effectively connected

1 with the conduct of a trade or business within the
2 United States,

3 may elect for such taxable year to treat all such income
4 as income which is effectively connected with the con-
5 duct of a trade or business within the United States.
6 In such case, such income shall be taxable as provided
7 in subsection (b) (1) whether or not such individual
8 is engaged in trade or business within the United States
9 during the taxable year. An election under this para-
10 graph for any taxable year shall remain in effect for
11 all subsequent taxable years, except that it may be re-
12 voked with the consent of the Secretary or his delegate
13 with respect to any taxable year.

14 “(2) ELECTION AFTER REVOCATION.—If an elec-
15 tion has been made under paragraph (1) and such elec-
16 tion has been revoked, a new election may not be made
17 under such paragraph for any taxable year before the
18 5th taxable year which begins after the first taxable
19 year for which such revocation is effective, unless the
20 Secretary or his delegate consents to such new election.

21 “(3) FORM AND TIME OF ELECTION AND REVO-
22 CATION.—An election under paragraph (1), and any
23 revocation of such an election, may be made only in
24 such manner and at such time as the Secretary or his
25 delegate may by regulations prescribe.

1 “(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 (2) Section 1 (relating to tax on individuals) is
3 amended by redesignating subsection (d) as subsection
4 (e), and by inserting after subsection (c) the follow-
5 ing new subsection:

6 “(d) NONRESIDENT ALIENS.—In the case of a non-
7 resident alien individual, the tax imposed by subsection (a)
8 shall apply only as provided by section 871 or 877.”

9 (b) GROSS INCOME.—

10 (1) Subsection (a) of section 872 (relating to
11 gross income of nonresident alien individuals) is amended
12 to read as follows:

13 “(a) GENERAL RULE.—In the case of a nonresident
14 alien individual, gross income includes only—

15 “(1) gross income which is derived from sources

1 within the United States and which is not effectively
2 connected with the conduct of a trade or business within
3 the United States, and

4 “(2) gross income which is effectively connected
5 with the conduct of a trade or business within the
6 United States.”

7 (2) Subparagraph (B) of section 872 (b) (3) (re-
8 lating to compensation of participants in certain ex-
9 change or training programs) is amended by striking
10 out “by a domestic corporation” and inserting in lieu
11 thereof “by a domestic corporation, a domestic partner-
12 ship, or an individual who is a citizen or resident of the
13 United States”.

14 (3) Subsection (b) of section 872 (relating to
15 exclusions from gross income) is amended by adding at
16 the end thereof the following new paragraph:

17 “(4) BOND INTEREST OF RESIDENTS OF THE
18 RYUKYU ISLANDS OR THE TRUST TERRITORY OF THE
19 PACIFIC ISLANDS.—Income derived by a nonresident
20 alien individual from a series E or series H United States
21 savings bond, if such individual acquired such bond while
22 a resident of the Ryukyu Islands or the Trust Territory
23 of the Pacific Islands.”

24 (c) DEDUCTIONS.—

25 (1) Section 873 (relating to deductions allowed to

1 nonresident alien individuals) is amended to read as
2 follows:

3 **"SEC. 873. DEDUCTIONS.**

4 “(a) **GENERAL RULE.**—In the case of a nonresident
5 alien individual, the deductions shall be allowed only for
6 purposes of section 871 (b) and (except as provided by sub-
7 section (b)) only if and to the extent that they are con-
8 nected with income which is effectively connected with the
9 conduct of a trade or business within the United States; and
10 the proper apportionment and allocation of the deductions
11 for this purpose shall be determined as provided in regula-
12 tions prescribed by the Secretary or his delegate.

13 “(b) **EXCEPTIONS.**—The following deductions shall be
14 allowed whether or not they are connected with income
15 which is effectively connected with the conduct of a trade
16 or business within the United States:

17 “(1) **LOSSES.**—The deduction, for losses of prop-
18 erty not connected with the trade or business if arising
19 from certain casualties or theft, allowed by section
20 165 (c) (3), but only if the loss is of property located
21 within the United States.

22 “(2) **CHARITABLE CONTRIBUTIONS.**—The deduc-
23 tion for charitable contributions and gifts allowed by
24 section 170.

1 “(3) **PERSONAL EXEMPTION.**—The deduction for
2 personal exemptions allowed by section 151, except that
3 in the case of a nonresident alien individual who is not a
4 resident of a contiguous country only one exemption
5 shall be allowed under section 151.

6 “(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).”

7 (2) Section 154 (3) (relating to cross references
8 in respect of deductions for personal exemptions) is
9 amended to read as follows:

 “(3) For exemptions of nonresident aliens, see section
 873(b)(3).”

10 (d) **ALLOWANCE OF DEDUCTIONS AND CREDITS.**—
11 Subsection (a) of section 874 (relating to filing of returns)
12 is amended to read as follows:

13 “(a) **RETURN PREREQUISITE TO ALLOWANCE.**—A
14 nonresident alien individual shall receive the benefit of the
15 deductions and credits allowed to him in this subtitle only
16 by filing or causing to be filed with the Secretary or his
17 delegate a true and accurate return, in the manner prescribed
18 in subtitle F (sec. 6001 and following, relating to procedure
19 and administration), including therein all the information
20 which the Secretary or his delegate may deem necessary
21 for the calculation of such deductions and credits. This sub-

1 section shall not be construed to deny the credits provided
 2 by sections 31 and 32 for tax withheld at source or the credit
 3 provided by section 39 for certain uses of gasoline and
 4 lubricating oil.”

5 (e) **EXPATRIATION TO AVOID TAX.**—

6 (1) Subpart A of part II of subchapter N of chap-
 7 ter 1 (relating to nonresident alien individuals) is
 8 amended by redesignating section 877 as section 878,
 9 and by inserting after section 876 the following new
 10 section:

11 **“SEC. 877. EXPATRIATION TO AVOID TAX.**

12 “(a) **IN GENERAL.**—Every nonresident alien individ-
 13 ual who at any time after March 8, 1965, and within the 5-
 14 year period immediately preceding the close of the taxable
 15 year lost United States citizenship, unless such loss did not
 16 have for one of its principal purposes the avoidance of taxes
 17 under this subtitle or subtitle B, shall be taxable for such
 18 taxable year in the manner provided in subsection (b) if the
 19 tax imposed pursuant to such subsection exceeds the tax
 20 which, without regard to this section, is imposed pursuant to
 21 section 871.

22 “(b) **ALTERNATIVE TAX.**—A nonresident alien individ-
 23 ual described in subsection (a) shall be taxable for the tax-
 24 able year as provided in section 1 or section 1201 (b),
 25 except that—

1 “(1) the gross income shall include only the gross
2 income described in section 872 (a) (as modified by
3 subsection (c) of this section), and

4 “(2) the deductions shall be allowed if and to the
5 extent that they are connected with the gross income
6 included under this section, except that the capital loss
7 carryover provided by section 1212 (b) shall not be
8 allowed; and the proper allocation and apportionment of
9 the deductions for this purpose shall be determined as
10 provided under regulations prescribed by the Secretary
11 or his delegate.

12 For purposes of paragraph (2), the deductions allowed by
13 section 873 (b) shall be allowed; and the deduction (for
14 losses not connected with the trade or business if incurred in
15 transactions entered into for profit) allowed by section
16 165 (c) (2) shall be allowed, but only if the profit, if such
17 transaction had resulted in a profit, would be included in
18 gross income under this section.

19 “(c) SPECIAL RULES OF SOURCE.—For purposes of
20 subsection (b), the following items of gross income shall
21 be treated as income from sources within the United States:

22 “(1) SALE OF PROPERTY.—Gains on the sale or
23 exchange of property (other than stock or debt obliga-
24 tions) located in the United States.

1 “(2) STOCK OR DEBT OBLIGATIONS.—Gains on the
2 sale or exchange of stock issued by a domestic corpora-
3 tion or debt obligations of United States persons or of
4 the United States, a State or political subdivision thereof,
5 or the District of Columbia.

6 “(d) EXCEPTION FOR LOSS OF CITIZENSHIP FOR CER-
7 TAIN CAUSES.—Subsection (a) shall not apply to a non-
8 resident alien individual whose loss of United States citizen-
9 ship resulted from the application of section 301 (b) , 350, or
10 355 of the Immigration and Nationality Act, as amended
11 (8 U.S.C. 1401 (b) , 1482, or 1487) .

12 “(e) BURDEN OF PROOF.—If the Secretary or his dele-
13 gate establishes that it is reasonable to believe that an indi-
14 vidual’s loss of United States citizenship would, but for this
15 section, result in a substantial reduction for the taxable year
16 in the taxes on his probable income for such year, the burden
17 of proving for such taxable year that such loss of citizen-
18 ship did not have for one of its principal purposes the
19 avoidance of taxes under this subtitle or subtitle B shall be
20 on such individual.”

21 (2) The table of sections for subpart A of part II
22 of subchapter N of chapter 1 (relating to nonresident
23 alien individuals) is amended by striking out the item

1 relating to section 877 and inserting in lieu thereof the
 2 following:

“Sec. 877. Expatriation to avoid tax.

“Sec. 878. Foreign educational, charitable, and certain other
 exempt organizations.”

3 (f) **PARTIAL EXCLUSION OF DIVIDENDS.**—Subsection
 4 (d) of section 116 (relating to certain nonresident aliens in-
 5 eligible for exclusion) is amended to read as follows:

6 “(d) **CERTAIN NONRESIDENT ALIENS INELIGIBLE FOR**
 7 **EXCLUSION.**—In the case of a nonresident alien individual,
 8 subsection (a) shall apply only—

9 “(1) in determining the tax imposed for the tax-
 10 able year pursuant to section 871 (b) (1) and only in
 11 respect of dividends which are effectively connected with
 12 the conduct of a trade or business within the United
 13 States, or

14 “(2) in determining the tax imposed for the tax-
 15 able year pursuant to section 877 (b).”

16 (g) **WITHHOLDING OF TAX ON NONRESIDENT**
 17 **ALIENS.**—Section 1441 (relating to withholding of tax on
 18 nonresident aliens) is amended—

19 (1) by striking out “(except interest on deposits
 20 with persons carrying on the banking business paid to
 21 persons not engaged in business in the United States)”
 22 in subsection (b) ;

23 (2) by striking out “and amounts described in sec-

tion 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

1 make a declaration of his estimated tax for the taxable year
2 if—”;

3 (2) by redesignating subsection (i) as subsection
4 (j) ; and

5 (3) by inserting after subsection (h) the follow-
6 ing new subsection:

7 “(i) NONRESIDENT ALIEN INDIVIDUALS.—No dec-
8 laration shall be required to be made under this section by a
9 nonresident alien individual unless—

10 “(1) withholding under chapter 24 is made appli-
11 cable to the wages, as defined in section 3401 (a), of
12 such individual,

13 “(2) such individual has income (other than com-
14 pensation for personal services subject to deduction and
15 withholding under section 1441) which is effectively
16 connected with the conduct of a trade or business within
17 the United States, or

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

20 (j) GAIN FROM DISPOSITIONS OF CERTAIN DEPRE-
21 CIABLE REALTY.—The second sentence of paragraph (3)
22 of section 1250 (d) (relating to certain tax-free transactions)
23 is amended to read as follows: “This paragraph shall not
24 apply to—

1 “(A) a disposition to an organization (other
2 than a cooperative described in section 521) which
3 is exempt from the tax imposed by this chapter, or

4 “(B) a transfer of property by a nonresident
5 alien individual, a foreign estate or trust, or a for-
6 eign partnership, to a domestic corporation in ex-
7 change for stock or securities in such corporation
8 in a transaction to which section 351 applies.”

9 (k) COLLECTION OF INCOME TAX AT SOURCE ON
10 WAGES.—Subsection (a) of section 3401 (relating to defini-
11 tion of wages for purposes of collection of income tax at
12 source) is amended by striking out paragraphs (6) and (7)
13 and inserting in lieu thereof the following:

14 “(6) for such services, performed by a nonresident
15 alien individual, as may be designated by regulations
16 prescribed by the Secretary or his delegate; or”.

17 (l) DEFINITION OF FOREIGN ESTATE OR TRUST.—
18 Section 7701 (a) (31) (defining foreign estate or trust) is
19 amended by striking out “from sources without the United
20 States” and inserting in lieu thereof “, from sources without
21 the United States which is not effectively connected with
22 the conduct of a trade or business within the United States,”.

23 (m) CONFORMING AMENDMENT.—The first sentence

1 of section 932 (a) (relating to citizens of possessions of the
2 United States) is amended to read as follows: "Any in-
3 dividual who is a citizen of any possession of the United
4 States (but not otherwise a citizen of the United States)
5 and who is not a resident of the United States shall be sub-
6 ject to taxation under this subtitle in the same manner and
7 subject to the same conditions as in the case of a nonresident
8 alien individual."

9 (n) **EFFECTIVE DATES.—**

10 (1) The amendments made by this section (other
11 than the amendments made by subsections (h) and
12 (k)) shall apply with respect to taxable years begin-
13 ning after December 31, 1966.

14 (2) The amendments made by subsection (h) shall
15 apply with respect to payments occurring after Decem-
16 ber 31, 1966.

17 (3) The amendments made by subsection (k) shall
18 apply with respect to remuneration paid after December
19 31, 1966.

20 **SEC. 4. FOREIGN CORPORATIONS.**

21 (a) **TAX ON INCOME NOT CONNECTED WITH UNITED**
22 **STATES BUSINESS.—**Section 881 (relating to tax on foreign

1 corporations not engaged in business in the United States)
 2 is amended to read as follows:

3 **"SEC. 881. INCOME OF FOREIGN CORPORATIONS NOT CON-**
 4 **NECTED WITH UNITED STATES BUSINESS.**

5 “(a) IMPOSITION OF TAX.—There is hereby imposed
 6 for each taxable year a tax of 30 percent of the amount
 7 received from sources within the United States by a foreign
 8 corporation as—

9 “(1) interest, dividends, rents, salaries, wages, pre-
 10 miums, annuities, compensations, remunerations, emolu-
 11 ments, and other fixed or determinable annual or
 12 periodical gains, profits, and income,

13 “(2) gains described in section 631 (b) or (c), and

14 “(3) amounts which under section 341, or under
 15 section 1232 (in the case of bonds or other evidences of
 16 indebtedness issued after September 28, 1965), are
 17 treated as gains from the sale or exchange of property
 18 which is not a capital asset,

19 but only to the extent the amount so received is not effec-
 20 tively connected with the conduct of a trade or business
 21 within the United States.

22 “(b) DOUBLING OF TAX.—

**“For doubling of tax on corporations of certain foreign
 countries, see section 891.”**

1 (b) TAX ON INCOME CONNECTED WITH UNITED
2 STATES BUSINESS.—

3 (1) Section 882 (relating to tax on resident for-
4 eign corporations) is amended to read as follows:

5 “SEC. 882. INCOME OF FOREIGN CORPORATIONS CON-
6 NECTED WITH UNITED STATES BUSINESS.

7 “(a) NORMAL TAX AND SURTAX.—

8 “(1) IMPOSITION OF TAX.—A foreign corporation
9 engaged in trade or business within the United States
10 during the taxable year shall be taxable as provided in
11 section 11 or 1201 (a) on its taxable income which is
12 effectively connected with the conduct of a trade or busi-
13 ness within the United States.

14 “(2) DETERMINATION OF TAXABLE INCOME.—In
15 determining taxable income for purposes of paragraph
16 (1), gross income includes only gross income which is
17 effectively connected with the conduct of a trade or
18 business within the United States.

19 “(b) GROSS INCOME.—In the case of a foreign corpora-
20 tion, gross income includes only—

21 “(1) gross income which is derived from sources
22 within the United States and which is not effectively

1 connected with the conduct of a trade or business with-
2 in the United States, and

3 “(2) gross income which is effectively connected
4 with the conduct of a trade or business within the
5 United States.

6 “(c) ALLOWANCE OF DEDUCTIONS AND CREDITS.—

7 “(1) ALLOCATION OF DEDUCTIONS.—

8 “(A) GENERAL RULE.—In the case of a for-
9 eign corporation, the deductions shall be allowed
10 only for purposes of subsection (a) and (except as
11 provided by subparagraph (B)) only if and to the
12 extent that they are connected with income which
13 is effectively connected with the conduct of a trade
14 or business within the United States; and the proper
15 apportionment and allocation of the deductions for
16 this purpose shall be determined as provided in
17 regulations prescribed by the Secretary or his
18 delegate.

19 “(B) CHARITABLE CONTRIBUTIONS.—The de-
20 duction for charitable contributions and gifts pro-
21 vided by section 170 shall be allowed whether or
22 not connected with income which is effectively con-
23 nected with the conduct of a trade or business
24 within the United States.

1 “(2) DEDUCTIONS AND CREDITS ALLOWED ONLY
 2 IF RETURN FILED.—A foreign corporation shall receive
 3 the benefit of the deductions and credits allowed to it
 4 in this subtitle only by filing or causing to be filed with
 5 the Secretary or his delegate a true and accurate return,
 6 in the manner prescribed in subtitle F, including therein
 7 all the information which the Secretary or his delegate
 8 may deem necessary for the calculation of such deduc-
 9 tions and credits. This paragraph shall not be construed
 10 to deny the credit provided by section 32 for tax with-
 11 held at source or the credit provided by section 39 for
 12 certain uses of gasoline and lubricating oil.

13 “(3) FOREIGN TAX CREDIT.—Except as provided
 14 by section 906, foreign corporations shall not be allowed
 15 the credit against the tax for taxes of foreign countries
 16 and possessions of the United States allowed by section
 17 901.

18 “(4) CROSS REFERENCE.—

 “For rule that certain foreign taxes are not to be taken
 into account in determining deduction or credit, see sec-
 tion 906(b)(1).

19 “(d) ELECTION TO TREAT REAL PROPERTY INCOME
 20 AS INCOME CONNECTED WITH UNITED STATES BUSI-
 21 NESS.—

1 “(1) IN GENERAL.—A foreign corporation which
2 during the taxable year derives any income—

3 “(A) from real property located in the United
4 States, or from any interest in such real property,
5 including (i) gains from the sale or exchange of
6 real property or an interest therein, (ii) rents or
7 royalties from mines, wells, or other natural de-
8 posits, and (iii) gains described in section 631 (b)
9 or (c), and

10 “(B) which, but for this subsection, would not
11 be treated as income effectively connected with the
12 conduct of a trade or business within the United
13 States,
14 may elect for such taxable year to treat all such income
15 as income which is effectively connected with the con-
16 duct of a trade or business within the United States. In
17 such case, such income shall be taxable as provided in
18 subsection (a) (1) whether or not such corporation is
19 engaged in trade or business within the United States
20 during the taxable year. An election under this para-
21 graph for any taxable year shall remain in effect for all
22 subsequent taxable years, except that it may be revoked
23 with the consent of the Secretary or his delegate with
24 respect to any taxable year.

1 “(2) ELECTION AFTER REVOCATION, ETC.—Para-
 2 graphs (2) and (3) of section 871 (d) shall apply in
 3 respect of elections under this subsection in the same
 4 manner and to the same extent as they apply in respect
 5 of elections under section 871 (d).

6 “(e) RETURNS OF TAX BY AGENT.—If any foreign
 7 corporation has no office or place of business in the United
 8 States but has an agent in the United States, the return
 9 required under section 6012 shall be made by the agent.”

10 (2) (A) Subsection (e) of section 11 (relating to
 11 exceptions from tax on corporations) is amended by in-
 12 serting “or” at the end of paragraph (2), by striking
 13 out “, or” at the end of paragraph (3) and inserting
 14 a period in lieu thereof, and by striking out paragraph
 15 (4).

16 (B) Section 11 (relating to tax on corporations) is
 17 amended by adding at the end thereof the following
 18 new subsection:

19 “(f) FOREIGN CORPORATIONS.—In the case of a foreign
 20 corporation, the tax imposed by subsection (a) shall apply
 21 only as provided by section 882.”

22 (3) The table of sections for subpart B of part II
 23 of subchapter N of chapter 1 is amended by striking out

1 the items relating to sections 881 and 882 and inserting
2 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.”

3 (c) WITHHOLDING OF TAX ON FOREIGN CORPORA-
4 TIONS.—Section 1442 (relating to withholding of tax on
5 foreign corporations) is amended to read as follows:

6 **“SEC. 1442. WITHHOLDING OF TAX ON FOREIGN CORPO-
7 RATIONS.**

8 “(a) GENERAL RULE.—In the case of foreign corpora-
9 tions subject to taxation under this subtitle, there shall be
10 deducted and withheld at the source in the same manner and
11 on the same items of income as is provided in section 1441
12 or section 1451 a tax equal to 30 percent thereof; except
13 that, in the case of interest described in section 1451 (relat-
14 ing to tax-free covenant bonds), the deduction and with-
15 holding shall be at the rate specified therein. For purposes
16 of the preceding sentence, the reference in section 1441 (c)
17 (1) to section 871 (b) (1) shall be treated as referring to
18 section 842 or section 882 (a), as the case may be.

19 “(b) EXEMPTION.—Subject to such terms and condi-
20 tions as may be provided by regulations prescribed by the
21 Secretary or his delegate, subsection (a) shall not apply in
22 the case of a foreign corporation engaged in trade or business
23 within the United States if the Secretary or his delegate de-

1 terminates that the requirements of subsection (a) imposes an
2 undue administrative burden and that the collection of the
3 tax imposed by section 881 on such corporation will not be
4 jeopardized by the exemption."

5 (d) DIVIDENDS RECEIVED FROM CERTAIN FOREIGN
6 CORPORATIONS.—Subsection (a) of section 245 (relating to
7 the allowance of a deduction in respect of dividends received
8 from a foreign corporation) is amended—

9 (1) by striking out "and has derived 50 percent
10 or more of its gross income from sources within the
11 United States," in that portion of subsection (a) which
12 precedes paragraph (1) and by inserting in lieu thereof
13 "and if 50 percent or more of the gross income of such
14 corporation from all sources for such period is effectively
15 connected with the conduct of a trade or business within
16 the United States,";

17 (2) by striking out "from sources within the United
18 States" in paragraph (1) and inserting in lieu thereof
19 "which is effectively connected with the conduct of a
20 trade or business within the United States";

21 (3) by striking out "from sources within the United
22 States" in paragraph (2) and inserting in lieu thereof
23 ", which is effectively connected with the conduct of a
24 trade or business within the United States,"; and

1 (4) by adding after paragraph (2) the following
2 new sentence:

3 “For purposes of this subsection, the gross income of the
4 foreign corporation for any period before the first taxable
5 year beginning after December 31, 1966, which is effec-
6 tively connected with the conduct of a trade or business
7 within the United States is an amount equal to the gross
8 income for such period from sources within the United
9 States.”

10 (e) UNRELATED BUSINESS TAXABLE INCOME.—The
11 last sentence of section 512(a) (relating to definition) is
12 amended to read as follows: “In the case of an organiza-
13 tion described in section 511 which is a foreign organiza-
14 tion, the unrelated business taxable income shall be its un-
15 related business taxable income which is effectively connected
16 with the conduct of a trade or business within the United
17 States.”

18 (f) CORPORATIONS SUBJECT TO PERSONAL HOLDING
19 COMPANY TAX.—Paragraph (7) of section 542(c) (re-
20 lating to corporations not subject to the personal holding
21 company tax) is amended to read as follows:

22 “(7) a foreign corporation, if all of its stock out-
23 standing during the last half of the taxable year is owned
24 by nonresident alien individuals, whether directly or in-

1 directly through foreign estates, foreign trusts, foreign
2 partnerships, or other foreign corporations;”.

3 (g) AMENDMENTS WITH RESPECT TO FOREIGN COR-
4 PORATIONS CARRYING ON INSURANCE BUSINESS IN
5 UNITED STATES.—

6 (1) Section 842 (relating to computation of gross
7 income) is amended to read as follows:

8 **“SEC. 842. FOREIGN CORPORATIONS CARRYING ON INSUR-**
9 **ANCE BUSINESS.**

10 “If a foreign corporation carrying on an insurance busi-
11 ness within the United States would qualify under part I,
12 II, or III of this subchapter for the taxable year if (without
13 regard to income not effectively connected with the conduct
14 of any trade or business within the United States) it were
15 a domestic corporation, such corporation shall be taxable
16 under such part on its income effectively connected with its
17 conduct of any trade or business within the United States.
18 With respect to the remainder of its income, which is from
19 sources within the United States, such a foreign corpora-
20 tion shall be taxable as provided in section 881.”

21 (2) The table of sections for part IV of subchapter
22 L of chapter 1 is amended by striking out the item re-

1 lating to section 842 and inserting in lieu thereof the
2 following:

 “Sec. 842. Foreign corporations carrying on insurance business.”

3 (3) Section 819 (relating to foreign life insurance
4 companies) is amended—

5 (A) by striking out subsections (a) and (d)
6 and by redesignating subsections (b) and (c) as
7 subsection (a) and (b),

8 (B) by striking out “In the case of any com-
9 pany described in subsection (a),” in subsection
10 (a) (1) (as redesignated by subparagraph (A))
11 and inserting in lieu thereof “In the case of any
12 foreign corporation taxable under this part,”

13 (C) by striking out “subsection (c)” in the
14 last sentence of subsection (a) (2) (as redesignated
15 by subparagraph (A)) and inserting in lieu thereof
16 “subsection (b)”,

17 (D) by adding at the end of subsection (a)
18 (as redesignated by subparagraph (A)) the fol-
19 lowing new paragraph:

20 “(3) REDUCTION OF SECTION 881 TAX.—In the
21 case of any foreign corporation taxable under this part,
22 there shall be determined—

23 “(A) the amount which would be subject to

1 tax under section 881 if the amount taxable under
 2 such section were determined without regard to sec-
 3 tions 103 and 894, and

4 “(B) the amount of the reduction provided
 5 by paragraph (1).

6 The tax under section 881 (determined without regard
 7 to this paragraph) shall be reduced (but not below
 8 zero) by an amount which is the same proportion of
 9 such tax as the amount referred to in subparagraph (B)
 10 is of the amount referred to in subparagraph (A) ; but
 11 such reduction in tax shall not exceed the increase in
 12 tax under this part by reason of the reduction provided
 13 by paragraph (1).”,

14 (E) by striking out “for purposes of subsec-
 15 tion (a)” each place it appears in subsection (b)
 16 (as redesignated by subparagraph (A)) and insert-
 17 ing in lieu thereof “with respect to a foreign
 18 corporation”,

19 (F) by striking out “foreign life insurance
 20 company” each place it appears in such subsection
 21 (b) and inserting in lieu thereof “foreign corpora-
 22 tion”,

23 (G) by striking out “subsection (b) (2) (A)”
 24 each place it appears in such subsection (b) and

1 inserting in lieu thereof "subsection (a) (2) (A)",
 2 (H) by striking out "subsection (b) (2) (B)"
 3 in paragraph (2) (B) (ii) of such subsection (b)
 4 and inserting in lieu thereof "subsection (a) (2)
 5 (B)", and

6 (I) by adding at the end thereof the following
 7 new subsection:

8 **"(c) CROSS REFERENCE.—**

"For taxation of foreign corporations carrying on life insurance business within the United States, see section 842."

9 (4) Section 821 (relating to tax on mutual insur-
 10 ance companies to which part II applies) is amended—

11 (A) by striking out subsection (e) and by
 12 redesignating subsections (f) and (g) as sub-
 13 sections (e) and (f), and

14 (B) by adding at the end of subsection (f)
 15 (as redesignated by subparagraph (A)) the fol-
 16 lowing:

"(3) For taxation of foreign corporations carrying on an insurance business within the United States, see section 842."

17 (5) Section 822 (relating to determination of tax-
 18 able investment income) is amended by striking out
 19 subsection (e) and by redesignating subsection (f) as
 20 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

1 the case of a controlled foreign corporation, subpart F in-
 2 come does not include any item of income from sources
 3 within the United States which is effectively connected
 4 with the conduct by such corporation of a trade or business
 5 within the United States unless such item is exempt from
 6 taxation (or is subject to a reduced rate of tax) pursuant
 7 to a treaty obligation of the United States.”

8 (i) GAIN FROM CERTAIN SALES OR EXCHANGES OF
 9 STOCK IN CERTAIN FOREIGN CORPORATIONS.—Paragraph
 10 (4) of section 1248(d) (relating to exclusions from earn-
 11 ings and profits) is amended to read as follows:

12 “(4) UNITED STATES INCOME.—Any item in-
 13 cludible in gross income of the foreign corporation under
 14 this chapter—

15 “(A) for any taxable year beginning before
 16 January 1, 1967, as income derived from sources
 17 within the United States of a foreign corporation
 18 engaged in trade or business within the United
 19 States, or

20 “(B) for any taxable year beginning after
 21 December 31, 1966, as income effectively con-
 22 nected with the conduct by such corporation of a
 23 trade or business within the United States.

24 This paragraph shall not apply with respect to any
 25 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.”

1 (2) Section 953 (b) (3) (F) is amended by strik-
 2 ing out "832 (b) (5)" and inserting in lieu thereof
 3 "832 (c) (5)".

4 (3) Section 1249 (a) is amended by striking out
 5 "Except as provided in subsection (c), gain" and in-
 6 serting in lieu thereof "Gain".

7 (1) **EFFECTIVE DATES.**—The amendments made by
 8 this section (other than subsection (i)) shall apply with
 9 respect to taxable years beginning after December 31, 1966.
 10 The amendment made by subsection (i) shall apply with
 11 respect to sales or exchanges occurring after December 31,
 12 1966.

13 **SEC. 5. SPECIAL TAX PROVISIONS.**

14 (a) **INCOME AFFECTED BY TREATY.**—Section 894 (re-
 15 lating to income exempt under treaties) is amended to read
 16 as follows:

17 **"SEC. 894. INCOME AFFECTED BY TREATY.**

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

22 "(b) **PERMANENT ESTABLISHMENT IN UNITED**
 23 **STATES.**—For purposes of applying any exemption from, or
 24 reduction of, any tax provided by any treaty to which the
 25 United States is a party with respect to income which is not

1 effectively connected with the conduct of a trade or business
 2 within the United States, a nonresident alien individual or a
 3 foreign corporation shall be deemed not to have a permanent
 4 establishment in the United States at any time during the
 5 taxable year. This subsection shall not apply in respect of
 6 the tax computed under section 877 (b)."

7 (b) APPLICATION OF PRE-1967 INCOME TAX PROVI-
 8 SIONS.—Subpart C of part II of subchapter N of chapter 1
 9 (relating to miscellaneous provisions applicable to nonresi-
 10 dent aliens and foreign corporations) is amended by adding
 11 at the end thereof the following new section:

12 "SEC. 896. APPLICATION OF PRE-1967 INCOME TAX PRO-
 13 VISIONS.

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

16 "(1) under the laws of any foreign country, con-
 17 sidering the tax system of such foreign country, citizens
 18 of the United States not residents of such foreign coun-
 19 try or domestic corporations are being subjected to more
 20 burdensome taxes, on any item of income received by
 21 such citizens or corporations from sources within such
 22 foreign country, than taxes imposed by the provisions of
 23 this subtitle on similar income derived from sources
 24 within the United States by residents or corporations of
 25 such foreign country,

1 “(2) such foreign country, when requested by the
2 United States to do so, has not acted to revise or reduce
3 such taxes so that they are no more burdensome than
4 taxes imposed by the provisions of this subtitle on similar
5 income derived from sources within the United States by
6 residents or corporations of such foreign country, and

7 “(3) it is in the public interest to apply pre-1967
8 tax provisions in accordance with the provisions of this
9 section to residents or corporations of such foreign
10 country,

11 the President shall proclaim that the tax on such similar in-
12 come derived from sources within the United States by resi-
13 dents or corporations of such foreign country shall, for tax-
14 able years beginning after such proclamation, be determined
15 under this subtitle without regard to amendments made to
16 this subchapter and chapter 3 on or after the date of enact-
17 ment of this section.

18 “(b) ALLEVIATION OF MORE BURDENSOME TAXES.—
19 Whenever the President finds that the laws of any foreign
20 country with respect to which the President has made a proc-
21 lamation under subsection (a) have been modified so that
22 citizens of the United States not residents of such foreign
23 country or domestic corporations are no longer subject to
24 more burdensome taxes on such item of income derived by

1 such citizens or corporations from sources within such foreign
 2 country, he shall proclaim that the tax on such similar in-
 3 come derived from sources within the United States by
 4 residents or corporations of such foreign country shall, for
 5 any taxable year beginning after such proclamation, be
 6 determined under this subtitle without regard to subsec-
 7 tion (a).

8 “(c) NOTIFICATION OF CONGRESS REQUIRED.—No
 9 proclamation shall be issued by the President pursuant to
 10 this section unless, at least 30 days prior to such procla-
 11 mation, he has notified the Senate and the House of Repre-
 12 sentatives of his intention to issue such proclamation.

13 “(d) IMPLEMENTATION BY REGULATIONS.—The Sec-
 14 retary or his delegate shall prescribe such regulations as he
 15 deems necessary or appropriate to implement this section.”

16 (c) CLERICAL AMENDMENTS.—The table of sections
 17 for subpart C of part II of subchapter N of chapter 1 is
 18 amended—

19 (1) by striking out the item relating to section 894
 20 and inserting in lieu thereof

“Sec. 894. Income affected by treaty.”;

21 (2) by adding at the end of such table the
 22 following:

“Sec. 896. Application of pre-1967 income tax provisions.”

1 (d) **EFFECTIVE DATE.**—The amendments made by this
 2 section (other than subsection (e)) shall apply with respect
 3 to taxable years beginning after December 31, 1966.

4 (e) **ELECTIONS BY NONRESIDENT UNITED STATES**
 5 **CITIZENS WHO ARE SUBJECT TO FOREIGN COMMUNITY**
 6 **PROPERTY LAWS.**—

7 (1) *Part III of subchapter N of chapter 1 (relat-*
 8 *ing to income from sources without the United States)*
 9 *is amended by adding at the end thereof the following new*
 10 *subpart:*

11 “**Subpart H—Income of Certain Nonresident United States**
 12 **Citizens Subject to Foreign Community Property Laws**

*“Sec. 981. Elections as to treatment of income subject to
 foreign community property laws.*

13 “**SEC. 981. ELECTION AS TO TREATMENT OF INCOME SUB-**
 14 **JECT TO FOREIGN COMMUNITY PROPERTY**
 15 **LAWS.**

16 “(a) **GENERAL RULE.**—*In the case of any taxable year*
 17 *beginning after December 31, 1966, if—*

18 “(1) *an individual is (A) a citizen of the United*
 19 *States, (B) a bona fide resident of a foreign country*
 20 *or countries during the entire taxable year, and (C)*
 21 *married at the close of the taxable year to a spouse who is*
 22 *a nonresident alien during the entire taxable year, and*

“(2) such individual and his spouse elect to have subsection (b) apply to their community income under foreign community property laws, then subsection (b) shall apply to such income of such individual and such spouse for the taxable year and for all subsequent taxable years for which the requirements of paragraph (1) are met, unless the Secretary or his delegate consents to a termination of the election.

“(b) *TREATMENT OF COMMUNITY INCOME.*—For any taxable year to which an election made under subsection (a) applies, the community income under foreign community property laws of the husband and wife making the election shall be treated as follows:

“(1) *Earned income* (within the meaning of the first sentence of section 911(b)), other than trade or business income and a partner's distributive share of partnership income, shall be treated as the income of the spouse who rendered the personal services.

“(2) *Trade or business income*, and a partner's distributive share of partnership income, shall be treated as provided in section 1402(a)(5).

“(3) *Community income* not described in paragraph (1) or (2) which is derived from the separate

1 *property (as determined under the applicable foreign*
 2 *community property law) of one spouse shall be treated*
 3 *as the income of such spouse.*

4 “(4) *All other such community income shall be*
 5 *treated as provided in the applicable foreign community*
 6 *property law.*

7 “(c) *ELECTION FOR PRE-1967 YEARS.—*

8 “(1) *ELECTION.—If an individual meets the re-*
 9 *quirements of subsection (a)(1) (A) and (C) for any*
 10 *taxable year beginning before January 1, 1967, and if*
 11 *such individual and the spouse referred to in subsection*
 12 *(a)(1)(C) elect under this subsection, then paragraph*
 13 *(2) of this subsection shall apply to their community in-*
 14 *come under foreign community property laws for all*
 15 *open taxable years beginning before January 1, 1967*
 16 *(whether under this chapter, the corresponding provi-*
 17 *sions of the Internal Revenue Code of 1939, or the cor-*
 18 *responding provisions of prior revenue laws), for which*
 19 *the requirements of subsection (a)(1)(A) and (C) are*
 20 *met.*

21 “(2) *EFFECT OF ELECTION.—For any taxable*
 22 *year to which an election made under this subsection*
 23 *applies, the community income under foreign community*
 24 *property laws of the husband and wife making the*

election shall be treated as provided by subsection (b), except that the other community income described in paragraph (4) of subsection (b) shall be treated as the income of the spouse who, for such taxable year, had gross income under paragraphs (1), (2), and (3) of subsection (b), plus separate gross income, greater than that of the other spouse.

“(d) *TIME FOR MAKING ELECTIONS; PERIOD OF LIMITATIONS; ETC.*—

“(1) *TIME.*—An election under subsection (a) or (c) for a taxable year may be made at any time while such year is still open, and shall be made in such manner as the Secretary or his delegate shall by regulations prescribe.

“(2) *EXTENSION OF PERIOD FOR ASSESSING DEFICIENCIES AND MAKING REFUNDS.*—If any taxable year to which an election under subsection (a) or (c) applies is open at the time such election is made, the period for assessing a deficiency against, and the period for filing claim for credit or refund of any overpayment by, the husband and wife for such taxable year, to the extent such deficiency or overpayment is attributable to such an election, shall not expire before 1 year after the date of such election.

1 “(3) *ALIEN SPOUSE NEED NOT JOIN IN SUBSEC-*
 2 *TION (c) ELECTION IN CERTAIN CASES.—If the Secre-*
 3 *tary or his delegate determines—*

4 “(A) *that an election under subsection (c)*
 5 *would not affect the liability for Federal income*
 6 *tax of the spouse referred to in subsection (a)(1)*
 7 *(C) for any taxable year, or*

8 “(B) *that the effect on such liability for tax*
 9 *cannot be ascertained and that to deny the election*
 10 *to the citizen of the United States would be inequita-*
 11 *ble and cause undue hardship,*

12 *such spouse shall not be required to join in such election,*
 13 *and paragraph (2) of this subsection shall not apply*
 14 *with respect to such spouse.*

15 “(4) *INTEREST.—To the extent that any overpay-*
 16 *ment or deficiency for a taxable year is attributable to*
 17 *an election made under this section, no interest shall be*
 18 *allowed or paid for any period before the day which is 1*
 19 *year after the date of such election.*

20 “(e) *DEFINITIONS AND SPECIAL RULES.—For pur-*
 21 *poses of this section—*

22 “(1) *DEDUCTIONS.—Deductions shall be treated in*
 23 *a manner consistent with the manner provided by this*
 24 *section for the income to which they relate.*

25 “(2) *OPEN YEARS.—A taxable year of a citizen*

1 of the United States and his spouse shall be treated as
 2 'open' if the period for assessing a deficiency against
 3 such citizen for such year has not expired before the
 4 date of the election under subsection (a) or (c), as the
 5 case may be.

6 “(3) *ELECTIONS IN CASE OF DECEDENTS.*—If a
 7 husband or wife is deceased his election under this section
 8 may be made by his executor, administrator, or other
 9 person charged with his property.

10 “(4) *DEATH OF SPOUSE DURING TAXABLE*
 11 *YEAR.*—In applying subsection (a)(1)(C), and in de-
 12 termining under subsection (c)(2) which spouse has the
 13 greater income for a taxable year, if a husband or wife
 14 dies the taxable year of the surviving spouse shall be
 15 treated as ending on the date of such death.”

16 (2) The table of subparts for such part III is
 17 amended by adding at the end thereof the following:

“Subpart H. *Income of certain nonresident United States
 citizens subject to foreign community prop-
 erty laws.*”

18 (3) Section 911(d) (relating to earned income
 19 from sources without the United States) is amended—

20 (A) by striking out “For administrative” and
 21 inserting in lieu thereof the following: “(1) For ad-
 22 ministrative”; and

1 (B) by adding at the end thereof the following:

 “(2) For elections as to treatment of income subject to
foreign community property laws, see section 981.”

2 **SEC. 6. FOREIGN TAX CREDIT.**

3 (a) ALLOWANCE OF CREDIT TO CERTAIN NONRESI-
4 DENT ALIENS AND FOREIGN CORPORATIONS.—

5 (1) Subpart A of part III of subchapter N of
6 chapter 1 (relating to foreign tax credit) is amended
7 by adding at the end thereof the following new section:

8 **“SEC. 906. NONRESIDENT ALIEN INDIVIDUALS AND FOR-
9 EIGN CORPORATIONS.**

10 “(a) ALLOWANCE OF CREDIT.—A nonresident alien
11 individual or a foreign corporation engaged in trade or
12 business within the United States during the taxable year
13 shall be allowed a credit under section 901 for the amount
14 of any income, war profits, and excess profits taxes paid or
15 accrued during the taxable year (or deemed, under section
16 902, paid or accrued during the taxable year) to any foreign
17 country or possession of the United States with respect to
18 income effectively connected with the conduct of a trade or
19 business within the United States.

20 “(b) SPECIAL RULES.—

21 “(1) For purposes of subsection (a) and for pur-
22 poses of determining the deductions allowable under
23 sections 873 (a) and 882 (c), in determining the amount

1 of any tax paid or accrued to any foreign country or
2 possession there shall not be taken into account any
3 amount of tax to the extent the tax so paid or accrued is
4 imposed with respect to income which would not be
5 taxed by such foreign country or possession but for the
6 fact that—

7 “(A) in the case of a nonresident alien indi-
8 vidual, such individual is a citizen or resident of
9 such foreign country or possession, or

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

15 “(2) For purposes of subsection (a), in applying
16 section 904 the taxpayer’s taxable income shall be
17 treated as consisting only of the taxable income effec-
18 tively connected with the taxpayer’s conduct of a trade
19 or business within the United States.

20 “(3) The credit allowed pursuant to subsection (a)
21 shall not be allowed against any tax imposed by section
22 871 (a) (relating to income of nonresident alien individ-
23 ual not connected with United States business) or 881
24 (relating to income of foreign corporations not con-
25 nected with United States business).

1 “(4) For purposes of sections 902 (a) and 78, a
2 foreign corporation choosing the benefits of this sub-
3 part which receives dividends shall, with respect to
4 such dividends, be treated as a domestic corporation.”

5 (2) The table of sections for such subpart A is
6 amended by adding at the end thereof the following:

“Sec. 906. Nonresident alien individuals and foreign cor-
porations.”

7 (3) Section 874 (c) is amended by striking out

8 “(c) FOREIGN TAX CREDIT NOT ALLOWED.—A non-
9 resident” and inserting in lieu thereof the following:

10 “(c) FOREIGN TAX CREDIT.—Except as provided in
11 section 906, a nonresident”.

12 (4) Subsection (b) of section 901 (relating to
13 amount allowed) is amended by redesignating para-
14 graph (4) as paragraph (5), and by inserting after
15 paragraph (3) the following new paragraph:

16 “(4) NONRESIDENT ALIEN INDIVIDUALS AND FOR-
17 EIGN CORPORATIONS.—In the case of any nonresident
18 alien individual not described in section 876 and in the
19 case of any foreign corporation, the amount determined
20 pursuant to section 906; and”.

21 (5) Paragraph (5) (as redesignated) of section
22 901 (b) is amended by striking out “or (3),” and in-
23 serting 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

1 citizens of the United States residing in such foreign
2 country a credit for any such taxes paid or accrued to
3 the United States or any foreign country, as the case
4 may be, similar to the credit allowed under subsection
5 (b) (3),

6 “(2) such foreign country, when requested by the
7 United States to do so, has not acted to provide such a
8 similar credit to citizens of the United States residing
9 in such foreign country, and

10 “(3) it is in the public interest to allow the credit
11 under subsection (b) (3) to citizens or subjects of such
12 foreign country only if it allows such a similar credit to
13 citizens of the United States residing in such foreign
14 country,

15 the President shall proclaim that, for taxable years begin-
16 ning while the proclamation remains in effect, the credit
17 under subsection (b) (3) shall be allowed to citizens or
18 subjects of such foreign country only if such foreign country,
19 in imposing income, war profits, and excess profits taxes,
20 allows to citizens of the United States residing in such foreign
21 country such a similar credit.”

22 (3) Section 2014 (relating to credit for foreign
23 death taxes) is amended by striking out the second sen-

1 tence of subsection (a), and by adding at the end of
2 such section the following new subsection:

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

5 “(1) a foreign country, in imposing estate, inherit-
6 ance, legacy, or succession taxes, does not allow to citi-
7 zens of the United States resident in such foreign coun-
8 try at the time of death a credit similar to the credit
9 allowed under subsection (a),

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

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

19 the President shall proclaim that, in the case of citizens or
20 subjects of such foreign country dying while the proclamation
21 remains in effect, the credit under subsection (a) shall be al-
22 lowed only if such foreign country allows such a similar

1 credit in the case of citizens of the United States resident in
2 such foreign country at the time of death."

3 (4) The amendments made by this subsection
4 (other than paragraph (3)) shall apply with respect
5 to taxable years beginning after December 31, 1966.
6 The amendment made by paragraph (3) shall apply
7 with respect to estates of decedents dying after the date
8 of the enactment of this Act.

9 (c) *FOREIGN TAX CREDIT IN CASE OF CERTAIN*
10 *OVERSEAS OPERATIONS FUNDING SUBSIDIARIES.*—

11 (1) *Section 904(f)(2) (relating to application of*
12 *limitations on foreign tax credit in case of certain inter-*
13 *est income) is amended—*

14 (A) *by striking out "or" at the end of subpara-*
15 *graph (C),*

16 (B) *by striking out the period at the end of sub-*
17 *paragraph (D) and inserting in lieu thereof ", or",*
18 *and*

19 (C) *by adding at the end thereof the following*
20 *new subparagraph:*

21 "(E) *received by an overseas operations fund-*
22 *ing subsidiary on obligations of a related foreign*
23 *corporation."*

(2) *Section 904(f) is amended by adding at the end thereof the following new paragraph:*

“(5) *DEFINITIONS FOR PURPOSES OF PARAGRAPH (1)(E).—For purposes of paragraph (1)(E).—*

“(A) *the term ‘overseas operations funding subsidiary’ means a domestic corporation which (i) is a member of an affiliated group (within the meaning of section 1504) and is not the common parent corporation, and (ii) was formed and is availed of for the principal purpose of raising funds outside the United States through public offerings to foreign persons and of using such funds to finance the operations in foreign countries of one or more related foreign corporations, and*

“(B) *a foreign corporation is, with respect to an overseas operations funding subsidiary, a related foreign corporation if the affiliated group of which such subsidiary is a member owns 50 percent or more of the voting stock of such foreign corporation either directly or through ownership of the voting stock of another foreign corporation.”*

(3) *The amendments made by paragraphs (1) and*

1 (2) shall apply to interest received after December 31,
 2 1965, in taxable years ending after such date.

3 **SEC. 7. AMENDMENT TO PRESERVE EXISTING LAW ON**
 4 **DEDUCTIONS UNDER SECTION 931.**

5 (a) DEDUCTIONS.—Subsection (d) of section 931 (re-
 6 lating to deductions) is amended to read as follows:

7 “(d) DEDUCTIONS.—

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

18 “(2) EXCEPTIONS.—The following deductions shall
 19 be allowed whether or not they are connected with in-
 20 come from sources within the United States:

21 “(A) The deduction, for losses not connected
 22 with the trade or business if incurred in transactions
 23 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, de-

1 terminated as provided in section 2106, of every decedent non-
 2 resident 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."

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

6 **"SEC. 2102. CREDITS AGAINST TAX.**

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

12 "(b) SPECIAL LIMITATION.—The maximum credit
 13 allowed under section 2011 against the tax imposed by sec-
 14 tion 2101 for State death taxes paid shall be an amount
 15 which bears the same ratio to the credit computed as pro-
 16 vided in section 2011 (b) as the value of the property, as
 17 determined for purposes of this chapter, upon which State

1 death taxes were paid and which is included in the gross
 2 estate under section 2103 bears to the value of the total gross
 3 estate under section 2103. For purposes of this subsection,
 4 the term 'State death taxes' means the taxes described in
 5 section 2011 (a)."

6 (c) PROPERTY WITHIN THE UNITED STATES.—Sec-
 7 tion 2104 (relating to property within the United States) is
 8 amended by adding at the end thereof the following new
 9 subsection:

10 "(c) DEBT OBLIGATIONS.—For purposes of this sub-
 11 chapter, debt obligations of—

12 "(1) a United States person, or

13 "(2) the United States, a State or any political
 14 subdivision thereof, or the District of Columbia,
 15 owned by a nonresident not a citizen of the United States
 16 shall be deemed property within the United States. This
 17 subsection shall not apply to a debt obligation of a domestic
 18 corporation if any interest on such obligation, were such in-
 19 terest received by the decedent at the time of his death,
 20 would be treated ~~under section 862(a)(1)~~ *by reason of*
 21 *section 861(a)(1)(B)* as income from sources without the
 22 United States."

23 (d) PROPERTY WITHOUT THE UNITED STATES.—Sub-

1 section (b) of section 2105 (relating to bank deposits) is
2 amended to read as follows:

3 “(b) DEPOSITS IN CERTAIN FOREIGN BRANCHES.—

4 For purposes of this subchapter, deposits with a foreign
5 branch of a domestic corporation, if such branch is engaged
6 in the commercial banking business, shall not be deemed
7 property within the United States.”

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

11 “(3) EXEMPTION.—

12 “(A) GENERAL RULE.—An exemption of
13 \$30,000.

14 “(B) RESIDENTS OF POSSESSIONS OF THE
15 UNITED STATES.—In the case of a decedent who is
16 considered to be a ‘nonresident not a citizen of the
17 United States’ under the provisions of section 2209,
18 the exemption shall be the greater of (i) \$30,000,
19 or (ii) that proportion of the exemption authorized
20 by section 2052 which the value of that part of the
21 decedent’s gross estate which at the time of his
22 death is situated in the United States bears to the
23 value of his entire gross estate wherever situated.”

24 (f) SPECIAL METHODS OF COMPUTING TAX.—Sub-

1 chapter B of chapter 11 (relating to estates of nonresidents
2 not citizens) is amended by adding at the end thereof the fol-
3 lowing new sections:

4 **"SEC. 2107. EXPATRIATION TO AVOID TAX.**

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

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

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

24 “(2) if such decedent owned (within the mean-

1 ing of section 958 (a)), or is considered to have owned
 2 (by applying the ownership rules of section 958 (b)),
 3 at the time of his death, more than 50 percent of the
 4 total combined voting power of all classes of stock en-
 5 titled to vote of such foreign corporation,
 6 then that proportion of the fair market value of the stock of
 7 such foreign corporation owned (within the meaning of sec-
 8 tion 958 (a)) by such decedent at the time of his death,
 9 which the fair market value of any assets owned by such for-
 10 eign corporation and situated in the United States, at the time
 11 of his death, bears to the total fair market value of all assets
 12 owned by such foreign corporation at the time of his death,
 13 shall be included in the gross estate of such decedent. For
 14 purposes of the preceding sentence, a decedent shall be
 15 treated as owning stock of a foreign corporation at the time
 16 of his death if, at the time of a transfer, by trust or otherwise,
 17 within the meaning of sections 2035 to 2038, inclusive, he
 18 owned such stock.

19 “(c) CREDITS.—The tax imposed by subsection (a)
 20 shall be credited with the amounts determined in accordance
 21 with section 2102.

22 “(d) EXCEPTION FOR LOSS OF CITIZENSHIP FOR CER-
 23 TAIN CAUSES.—Subsection (a) shall not apply to the trans-
 24 fer of the estate of a decedent whose loss of United States
 25 citizenship resulted from the application of section 301 (b) ,

1 350, or 355 of the Immigration and Nationality Act, as
 2 amended (8 U.S.C. 1401 (b), 1482, or 1487).

3 “(e) BURDEN OF PROOF.—If the Secretary or his dele-
 4 gate establishes that it is reasonable to believe that an indi-
 5 vidual’s loss of United States citizenship would, but for this
 6 section, result in a substantial reduction in the estate, in-
 7 heritance, legacy, and succession taxes in respect of the
 8 transfer of his estate, the burden of proving that such loss of
 9 citizenship did not have for one of its principal purposes the
 10 avoidance of taxes under this subtitle or subtitle A shall be
 11 on the executor of such individual’s estate.

12 “SEC. 2108. APPLICATION OF PRE-1967 ESTATE TAX PRO-
 13 VISIONS.

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

16 “(1) under the laws of any foreign country, con-
 17 sidering the tax system of such foreign country, a more
 18 burdensome tax is imposed by such foreign country on
 19 the transfer of estates of decedents who were citizens of
 20 the United States and not residents of such foreign
 21 country than the tax imposed by this subchapter on the
 22 transfer of estates of decedents who were residents of
 23 such foreign country,

24 “(2) such foreign country, when requested by the
 25 United States to do so, has not acted to revise or reduce

1 such tax so that it is no more burdensome than the tax
 2 imposed by this subchapter on the transfer of estates
 3 of decedents who were residents of such foreign country,
 4 and

5 “(3) it is in the public interest to apply pre-1967
 6 tax provisions in accordance with this section to the
 7 transfer of estates of decedents who were residents of
 8 such foreign country,
 9 the President shall proclaim that the tax on the transfer of
 10 the estate of every decedent who was a resident of such for-
 11 eign country at the time of his death shall, in the case of
 12 decedents dying after the date of such proclamation, be
 13 determined under this subchapter without regard to amend-
 14 ments made to sections 2101 (relating to tax imposed),
 15 2102 (relating to credits against tax), *2106 (relating to*
 16 *taxable estate)*, and 6018 (relating to estate tax returns)
 17 on or after the date of enactment of this section.

18 “(b) ALLEVIATION OF MORE BURDENSOME TAX.—
 19 Whenever the President finds that the laws of any foreign
 20 country with respect to which the President has made a proc-
 21 lamation under subsection (a) have been modified so that
 22 the tax on the transfer of estates of decedents who were
 23 citizens of the United States and not residents of such
 24 foreign country is no longer more burdensome than the
 25 tax imposed by this subchapter on the transfer of estates

1 of decedents who were residents of such foreign country,
 2 he shall proclaim that the tax on the transfer of the
 3 estate of every decedent who was a resident of such
 4 foreign country at the time of his death shall, in the case
 5 of decedents dying after the date of such proclamation, be
 6 determined under this subchapter without regard to sub-
 7 section (a).

8 “(c) NOTIFICATION OF CONGRESS REQUIRED.—No
 9 proclamation shall be issued by the President pursuant to
 10 this section unless, at least 30 days prior to such proclama-
 11 tion, he has notified the Senate and the House of Repre-
 12 sentatives of his intention to issue such proclamation.

13 “(d) IMPLEMENTATION BY REGULATIONS.—The Sec-
 14 retary or his delegate shall prescribe such regulations as may
 15 be necessary or appropriate to implement this section.”

16 (g) ESTATE TAX RETURNS.—Paragraph (2) of sec-
 17 tion 6018 (a) (relating to estates of nonresidents not citi-
 18 zens) is amended by striking out “\$2,000” and inserting in
 19 lieu thereof “\$30,000”.

20 (h) CLERICAL AMENDMENT.—The table of sections for
 21 subchapter B of chapter 11 (relating to estates of nonresi-
 22 dents not citizens) is amended by adding at the end thereof
 23 the following:

“Sec. 2107. Expatriation to avoid tax.

“Sec. 2108. Application of pre-1967 estate tax provisions.”

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

4 **SEC. 9. TAX ON GIFTS OF NONRESIDENTS NOT CITIZENS.**

5 (a) **IMPOSITION OF TAX.**—Subsection (a) of section
 6 2501 (relating to general rule for imposition of tax) is
 7 amended to read as follows:

8 “(a) **TAXABLE TRANSFERS.**—

9 “(1) **GENERAL RULE.**—For the calendar year
 10 1955 and each calendar year thereafter a tax, computed
 11 as provided in section 2502, is hereby imposed on the
 12 transfer of property by gift during such calendar year by
 13 any individual, resident or nonresident.

14 “(2) **TRANSFERS OF INTANGIBLE PROPERTY.**—
 15 Except as provided in paragraph (3), paragraph (1)
 16 shall not apply to the transfer of intangible property by
 17 a nonresident not a citizen of the United States.

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

23 “(A) such donor’s loss of United States citi-
 24 zenship resulted from the application of section
 25 301 (b), 350, or 355 of the Immigration and Na-

tionality 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

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

5 (c) **EFFECTIVE DATE.**—The amendments made by this
6 section shall apply with respect to the calendar year 1967
7 and all calendar years thereafter.

8 **SEC. 10. TREATY OBLIGATIONS.**

9 No amendment made by this Act shall apply in any case
10 where its application would be contrary to any treaty obliga-
11 tion of the United States. For purposes of the preceding
12 sentence, the extension of a benefit provided by any amend-
13 ment made by this Act shall not be deemed to be contrary
14 to a treaty obligation of the United States.

SECTION 17
COMMITTEE REPORT

FOREIGN INVESTORS TAX ACT OF 1966

R E P O R T

OF THE

COMMITTEE ON WAYS AND MEANS

HOUSE OF REPRESENTATIVES

TO ACCOMPANY

H.R. 13103

**A BILL TO PROVIDE EQUITABLE TAX TREATMENT
FOR FOREIGN INVESTMENT IN THE UNITED STATES**



APRIL 26, 1966.—Committed to the Committee of the Whole House
on the State of the Union and ordered to be printed

U.S. GOVERNMENT PRINTING OFFICE
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FOREIGN INVESTORS TAX ACT OF 1966

APRIL 26, 1966.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. MILLS, from the Committee on Ways and Means, submitted the following

R E P O R T

[To accompany H.R. 13103]

The Committee on Ways and Means, to whom was referred the bill (H.R. 13103) to amend the Internal Revenue Code of 1954 to provide equitable tax treatment for foreign investment in the United States, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments appear in the reported bill in stricken-through type and in italic type.

I. SUMMARY

The foreign investors tax bill of 1966, H.R. 13103, is designed to provide more equitable tax treatment for foreign investment in the United States. This is the first time the U.S. tax treatment of non-resident aliens and foreign corporations has been systematically revised in over 25 years. This legislation has been carefully studied and reviewed by your committee. This legislation has been developed by your committee from earlier proposals made to it by the Treasury Department.

It is anticipated that this bill will increase revenues by slightly over \$1 million on an annual basis. In addition, in the fiscal year 1967 there is expected to be, in that one year only, a revenue gain of \$22.5 million.

This bill is reported favorably by your committee, and its passage is urged by the Treasury Department.

A summary of the principal changes made by this bill, for the most part presented in the order in which they appear, is as follows:

1. *Interest on deposits in foreign branch banks of domestic corporations.*—Interest on deposits with foreign branch banks of U.S. corporations is to be treated as foreign source income, and thus free of U.S. income tax when paid to nonresident aliens and foreign corporations.

2. *Source rules for bank deposit interest and similar income.*—After December 31, 1971, all interest on U.S. bank deposits (other than those described in No. 1 above), whether or not effectively connected with a U.S. business, is to be treated as U.S. source income (and subject to U.S. income tax) in the case of nonresident aliens and foreign corporations. Until then, this interest on bank deposits, interest paid on accounts with mutual savings banks, domestic building and loan associations, etc., and interest on amounts held by insurance companies on deposit also are to be treated as foreign source income (unless effectively connected with a U.S. business) and thereby free of U.S. income tax.

3. *Rules for determining the source of dividends from foreign corporations.*—The source rule with respect to dividends paid by foreign corporations is amended to provide that dividends received from a foreign corporation are to be considered as having a U.S. source only if 80 percent of the corporation's gross income for the prior 3 years was effectively connected with the conduct of a trade or business in the United States.

4. *Compensation for personal services.*—The special source rule, providing that certain payments of compensation for services performed in the United States by a nonresident alien are treated as foreign source income (and therefore free of U.S. tax) if the services are performed for a foreign office of a U.S. corporation, is extended to services performed for a foreign office of a proprietor who is a citizen or resident of the United States or for the foreign office of a domestic partnership.

5. *Trading in stocks or securities or in commodities.*—Except in the case of dealers and certain investment companies, trading in stocks or securities in the United States, for one's own account, whether by a foreign investor physically present in the United States, through an employee located here, or through a resident agent (whether or not the agent has discretionary authority) is not to constitute a trade or business in the United States for income tax purposes. A parallel rule is provided for those trading in commodities.

6. *Income effectively connected with the conduct of a trade or business in the United States.*—The benchmark to be used in determining whether income is to be subject to a flat 30-percent rate or taxed substantially the same as income earned here by a U.S. citizen or domestic corporation is whether or not the income is effectively connected with a U.S. business. In the case of investment and other fixed or determinable income and capital gains from U.S. sources the income is to be treated as effectively connected with a U.S. business if the income is

derived from assets used or held for use in the conduct of a U.S. business or if the activities of the U.S. business were a material factor in the realization of the income. All other types of U.S. source income are to be considered to be effectively connected if there is a U.S. business. Income from sources without the United States will not be treated as effectively connected with a U.S. business unless the nonresident alien or foreign corporation has a fixed place of business in the United States and the income is attributable to that place of business. Moreover, in general only rents and royalties from licensing, income from banking and so forth, and sales income are to be taken into account for this purpose and only to the extent the income is not "subpart F" income or income derived from a foreign corporation 50-percent owned by the nonresident alien or foreign corporation receiving the income.

7. *Income tax on nonresident alien individuals.*—The income of nonresident aliens which is effectively connected with a U.S. business is to be taxed at the regular graduated rates applicable to individuals and all income not so connected is to be taxed at a flat 30-percent rate (or lower applicable treaty rate). U.S. source capital gains of a nonresident alien not engaged in business in the United States are to be taxed only if the alien was in the United States for 183 days or more during the year. Deductions are allowable only to the extent allocable to income which is effectively connected to a U.S. business. Also, an election is provided which allows an alien to treat income from real property as U.S. business income in order to take deductions allocable to it.

8. *Expatriation to avoid income tax.*—U.S. source income and the effectively connected income of a citizen received for 5 years after expatriation is, in most cases, to be taxed at the regular U.S. tax rates if a principal purpose of the expatriation was the avoidance of U.S. income, estate, or gift taxes.

9. *Withheld taxes and declarations of estimated income tax.*—The Treasury Department is authorized to require payment of amounts withheld from nonresident aliens and foreign corporations on a more current basis, rather than the annual basis presently provided. It is expected that quarterly payments will be required. Nonresident aliens who receive income which is effectively connected with the conduct of a U.S. business are to be required to file declarations of estimated tax.

10. *Income tax on foreign corporations.*—The regular corporate income tax is to apply to income of foreign corporations which is effectively connected with a U.S. business. U.S. source income which is not so connected is taxable at a flat 30-percent rate (or at a lower treaty rate). Foreign corporations are given an election to treat real property income as business income similar to that afforded nonresident aliens.

11. *Foreign corporations carrying on insurance business in the United States.*—A foreign corporation carrying on a life insurance business within the United States is to be taxed under the present special insurance company provisions on its income effectively connected with a U.S. business. The remainder of the income of this type of corporation from sources within the United States is to be taxed in the same manner as income of other corporations which is not

effectively connected; that is, at a flat 30-percent rate. An adjustment also is made to avoid double taxation which might result from the interaction of the minimum surplus provision for life insurance companies under present law and the new method of taxing foreign life insurance companies.

12. Application of pre-1967 income, estate and gift tax provisions.—The President is authorize to reinstate the income, estate, or gift tax provisions in effect prior to the enactment of this bill in the case of foreigners upon a determination that the foreign country in which they are residents or were incorporated is imposing more burdensome taxes on U.S. citizens or domestic corporations on income from sources within the foreign country than the U.S. tax on similar U.S. source income of foreigners.

13. Foreign community property income.—A U.S. citizen who is married to a nonresident alien, resident in a foreign country with community property laws, is to have an election for post-1966 years to treat the community income of the husband and wife as income of the person who earns it or, in the case of trade or business income, as income of the husband unless the wife manages the business. Income from separate property is to be treated as income of the person owning the property. All other community income is to be governed by the applicable foreign community property law. For open pre-1967 years, an election may also be made and the rules set forth above govern except that the other community income is to be treated as the income of the person who had the greater income from the other community income categories plus separate income.

14. Foreign tax credit.—A foreign tax credit is to be allowed nonresident aliens and foreign corporations with respect to foreign taxes on foreign source income which is effectively connected to the conduct of a U.S. business. However, the credit is not to include taxes paid to the foreigner's home country on grounds other than that the income was derived from sources within that country.

15. Similar income tax credit requirement.—Under present law a foreign tax credit is denied to citizens of a foreign country who are resident in the United States if the foreign country does not allow a similar credit to U.S. citizens who are resident in the foreign country. In the future the credit is to be denied only where the President finds that this is in the public interest and the foreign country refuses to grant U.S. citizens such a credit when requested to do so.

16. Overseas operations funding subsidiaries.—The separate application of the limitation on the foreign tax credit for interest income is not to apply to a domestic funding subsidiary which is formed and availed of for the principal purpose of (1) raising funds outside the United States through foreign public offerings, and (2) using these funds to finance the foreign operations of related foreign corporations.

17. Estate tax rates, exemptions, and returns.—A separate schedule of estate tax rates is made applicable to estates of nonresident aliens. The rates are graduated from 5 percent on the first \$100,000 of a taxable estate to 25 percent on the portion which exceeds \$2 million. The exemption also is raised from \$2,000 to \$30,000. These two measures are designed to accord approximately the same tax treat-

ment in the case of the estate of a nonresident alien as is accorded a similar-sized estate of a citizen eligible for a marital deduction. The filing requirement for returns for the estates of these nonresident aliens also is raised from \$2,000 to \$30,000.

18. *Situs rule for bonds*.—For purposes of the tax imposed on the estates of nonresident aliens, bonds of a U.S. person, the United States, a State, or political subdivision owned by a nonresident not a citizen of the United States, are to be considered property within the United States and therefore subject to U.S. estate tax. This rule already applies in the case of other forms of debt obligations.

19. *Situs rule for bank deposits*.—Bank deposits of nonresident aliens are to be treated as property within the United States and therefore subject to U.S. estate tax.

20. *Situs rule for deposits in foreign branch banks*.—Deposits in a foreign branch bank of a U.S. corporation are to be treated as property without the United States and therefore not includible in a foreigner's U.S. estate tax base.

21. *Expatriation to avoid estate tax*.—The estate of a nonresident alien is to be taxed at the regular U.S. estate tax rates if, within 10 years of his death, the alien had expatriated from the United States with a principal purpose of avoiding U.S. taxes.

22. *Tax on gifts of nonresident aliens*.—Transfers of intangible property by nonresident aliens are not to be subject to gift tax whether or not they are engaged in business in the United States. However, gifts of intangibles made by citizens who became expatriates within 10 years of making the gift are to be subject to gift tax if the avoidance of income, estate or gift taxes was a principal purpose for their becoming an expatriate. In the case of a person who expatriated for tax avoidance reasons, debt obligations of a U.S. person, or of the United States or a State or political subdivision are to be treated as having a situs in the United States.

23. *Treaty obligations*.—No amendment made by this bill is to apply in any case where its application would be contrary to any treaty obligation of the United States. However, the granting of a benefit provided by an amendment made by this bill is not to be considered to be contrary to a treaty obligation. Thus, even though a nonresident alien or foreign corporation has a permanent establishment in the United States, income which is not effectively connected with this business is to be taxed at the applicable treaty rate rather than at the regular individual or corporate rate.

II. PURPOSE AND BACKGROUND OF THE BILL

On October 2, 1963, the President appointed a task force on "Promoting Increased Foreign Investment in U.S. Corporate Securities and Increased Foreign Financing for U.S. Corporations Operating Abroad." On April 27, 1964, a report of this task force was released. Among the recommendations of the task force were a series of proposals designed to modify the U.S. taxation of foreign investors. The Treasury Department studied the recommendations of the task force and on March 8, 1965, submitted to the Congress proposed tax legislation designed to increase foreign investment in the United

States. At the request of the administration, Chairman Mills introduced a bill on that date, H. R. 5916, designed to carry out the recommendations of the Treasury Department. As stated by the Treasury Department, the proposed legislation was a part of the President's program to improve the U.S. balance of payments. The changes included in the proposed legislation were designed to stimulate foreign investment in the United States by modifying existing tax rules which are not consistent with sound tax policy and act as barriers to such investment.

On June 30 and July 1, 1965, your committee held public hearings on H.R. 5916. Following these hearings, the committee considered the bill at length in executive sessions. On the basis of these considerations a new version of the bill, H.R. 11297, was introduced by Chairman Mills on September 28, 1965, at the instruction of your committee in order to make it available for the information of the general public. Comments were requested on this revised version of the bill for the committee's consideration of the bill in 1966.

The committee, in its executive sessions in 1965, modified considerably the objectives of the earlier bill. The bill as modified by your committee sought, as its primary objective, the equitable tax treatment by the United States of nonresident aliens and foreign corporations. While, as stated above, the initial bill proposed by the Treasury Department was designed primarily to stimulate investments by foreigners in the United States, your committee considered more generally the tax provisions of present law affecting nonresident aliens and foreign corporations.

Your committee concluded in the course of its analysis that considerable revision and modification of the tax treatment accorded these persons were justified. Although the tax laws have been substantially revised on several occasions in recent years, the tax treatment of nonresident aliens and foreign corporations has not been appreciably changed in over 25 years.

Some of the revisions made in H.R. 11297 were a matter of concern to taxpayers as indicated by the comments received by the committee following the end of the first session of this Congress. As a result, your committee reconsidered the bill in executive session, analyzing these various comments and, on this basis, on February 28, 1966, Chairman Mills introduced a further revised bill, H.R. 13103. Public hearings were held on this bill on March 7, 1966. Following these hearings, the bill was again considered in executive session and it is favorably reported with amendments.

The foreign investors tax bill, as reported here, contains a broad revision of the present method of taxing income derived from the United States by foreign individuals and corporations. The legislation is designed to increase the equity of the tax treatment accorded foreign investment in the United States.

III. REVENUE ESTIMATES

It is expected that the bill, as presented here, will result in a revenue gain at current income and investment levels of slightly over \$1 million a year. In addition, the provision in the bill calling for quarterly payments of withheld taxes, instead of annual payments, is expected

to increase collections in the fiscal year 1967 alone by \$22.5 million. Table 1 shows the revenue gain or loss attributable to the various provisions in the bill to the extent this can be quantified.

TABLE 1.—*Estimated revenue changes resulting from the foreign investors tax bill*

Tax proposals	Revenue gain or loss (—)		
	Gain	Loss	Net
A. Elimination of progressive taxation of U.S. source income of nonresident alien individuals not engaged in trade or business in the United States.....		—\$748,000	—\$748,000
B. Estate tax at top rate of 25 percent on intangibles and tangibles with \$30,000 exemption.....		—3,000,000	—3,000,000
1. Tax on excluded bank deposits.....	\$300,000		300,000
C. Taxation of foreign life insurance company income from nontruster investments in the United States.....	3,000,000		3,000,000
D. Saving in interest cost to U.S. Government resulting from quarterly payment of withheld taxes.....	1,593,000		1,593,000
E. Tax on capital gains.....		—50,000	—50,000
Total.....	4,893,000	—3,798,000	1,095,000

NOTE.—Based on the most recently available withholding tax information, quarterly payment of withheld taxes will result in a revenue gain of \$22,500,000 in the fiscal year 1967. Taxes will be collected for 5 quarters in the fiscal year 1967. All 1966 withholding, estimated at \$90,000,000, will be collected on March 15, 1967, plus tax of \$22,500,000 for the 1st quarter of 1967 on April 15, 1967.

IV. GENERAL EXPLANATION

A. INCOME TAX SOURCE RULES

1. Rules for determining source of certain interest payments (sec. 2(a) (1) of the bill and secs. 861 (a) and (c) of the code)

(a) *Present law.*—Present law provides that nonresident alien individuals and foreign corporations are subject to U.S. tax only on the income they derive from sources within the United States. For purposes of determining whether the income is from within or without the United States, the code specifically enumerates types of income treated as income from sources within and as income from sources without the United States.

One of the rules under present law provides that interest on deposits paid to persons not engaged in trade or business in the United States is to be treated as income from sources without the United States if the interest is paid by a bank. The Internal Revenue Service in interpreting this rule has held that, in addition to banks, the provision applies to certain deposits with some types of State-chartered savings and loan associations. However, the Service has not interpreted this provision as extending to interest paid on deposits with all savings and loan associations or all types of deposits. Additionally, interest on similar deposits with insurance companies has not been accorded the benefits of this special rule.

(b) *Reasons for provision.*—Your committee believes that it is questionable whether interest income of this type, which is so clearly derived from U.S. sources, should be treated as though derived from sources without the United States and thereby escape U.S. taxation. At the same time, however, your committee realizes that an immediate alteration of the present source rule might have a substantial adverse effect on our balance of payments. To meet these two quite different

problems your committee's bill repeals this special foreign-source rule but also postpones the effective date of the repeal until after 1971. At that time your committee will have an opportunity to reconsider the balance-of-payments situation.

It also is the opinion of your committee that, as long as bank deposit interest is to be treated as foreign source income, there is no justification for denying similar treatment for interest paid by savings and loan institutions generally as well as interest earned on the proceeds of an insurance policy which are left on deposit with an insurance company. These all represent interest income received on deposits and, therefore, it is believed that the competing businesses should be treated in the same manner for tax purposes.

(c) *Explanation of provision.*—For the above reasons your committee has amended present law to provide that after December 31, 1971, interest on deposits with U.S. banks paid to nonresident alien individuals or foreign corporations is to be treated as income from sources within the United States. Therefore, until 1972 only interest which is effectively connected with the conduct of a trade or business in the United States will be subject to U.S. tax.¹ In addition, during the intervening 5-year period your committee has extended the application of the foreign source rule of present law to interest (or so-called dividends) paid on deposits (or withdrawable accounts) with all chartered and supervised savings and loan associations or similar institutions, to the extent these amounts are deductible in computing the taxable income of these institutions. Similar institutions for this purpose include mutual savings banks, cooperative banks, and domestic building and loan associations. Also, during this 5-year period, this special foreign source rule is to be applicable to interest on amounts held by insurance companies under an agreement to pay interest. The amounts paid by insurance companies to which this rule is extended include: (1) interest paid on policyholder dividends left with the company to accumulate; (2) interest paid on prepaid insurance premiums; (3) interest paid on proceeds of policies left on deposit; and (4) interest paid on overcharges of premiums.

(d) *Effective date.*—Except for the provision repealing the special foreign source rule for certain interest as of December 31, 1971, these amendments are effective with respect to taxable years beginning after December 31, 1966.

2. *Interest on deposits in foreign branch banks of domestic corporations (sec. 2(a)(2) of the bill, sec. 861(a)(1)(D) of the code)*

(a) *Present law.*—Present law provides that interest paid to nonresident alien individuals or foreign corporations on deposits with foreign branch banks of U.S. corporations, although paid by the foreign branch situated abroad, is treated as from sources within the United States if the recipient of the interest is engaged in a trade or business in the United States. This is true whether the deposits are payable in dollars or in the currency of the foreign country where the branch is located.

(b) *Reasons for provision.*—As a result of the rule described above nonresident aliens and foreign corporations often are reluctant to

¹ The term "effectively connected" is explained subsequently in No. B-2 below under sec. 2(d) of the bill.

deposit funds with foreign branch banks of U.S. corporations since, if (for other reasons) they are considered to be engaged in a trade or business in the United States, the interest paid on their deposits in these foreign branches is subject to U.S. tax. Their reluctance is increased by the fact that foreign persons engaged in business in the United States can avoid U.S. tax on the interest their bank deposits earn by keeping their funds in a bank chartered in their own country or any other country other than the United States, rather than in the foreign branch bank of a U.S. corporation. As a result, foreign branch banks of U.S. corporations are at a serious competitive disadvantage with the banks chartered in the country where they are doing business.

(c) *Explanation of provision.*—To place foreign branch banks of U.S. corporations in a competitive position with the other banks in the foreign countries where they are doing business, your committee's bill provides that the interest on deposits paid by these institutions is to be treated as foreign source income. Thus, nonresident aliens and foreign corporations will not be subject to U.S. tax on this type of interest income.

(d) *Effective date.*—This amendment is effective with respect to taxable years beginning after December 31, 1966.

3. *Foreign central banks and the Bank for International Settlements*
(sec. 2(a)(3)(A) of the bill and sec. 895 of the code)

(a) *Present law.*—Under present law interest received by a foreign central bank of issue from obligations of the U.S. Government is exempt from U.S. tax unless the obligations are used by the central bank in commercial transactions. In addition foreign central banks of issue and the Bank for International Settlements are not subject to tax on interest income from their U.S. bank deposits since bank-deposit interest received by nonresident aliens and foreign corporations not engaged in a trade or business within the United States is deemed to be from sources without the United States.

The central banks of issue are generally the custodians of the banking reserves of their countries and usually carry on most of the monetary functions of their countries in much the same way as our Federal Reserve Board. The Bank for International Settlements is an international organization, in practice, used primarily to aid European central banks of issue in their international financial operations, to promote cooperation among these central banks and to act as trustee in regard to certain international financial settlements. At present, all the central banks of Europe, except that of the Soviet Union, belong to the Bank for International Settlements and over 90 percent of the Bank's deposits are owned by these central banks.

(b) *Reasons for provision.*—By reason of the present exemption of bank-deposit interest paid and the exemption of interest income on their holdings of U.S. Government bonds, foreign central banks of issue in the past have been effectively exempt from practically all U.S. tax. Presumably this was done on the grounds that these foreign central banks of issue, through their monetary activities, were for the most part carrying on essential governmental activities for their foreign governments. However, with the termination in 1971 (as provided elsewhere in this bill) of the foreign source rule for bank-deposit interest, the United States would begin taxing bank-deposit

interest income of these foreign central banks. Your committee believes that in the case of these foreign central banks of issue this income should continue to be exempt from U.S. tax because of the nature of the activities these banks perform for their governments.

Your committee also concluded that the Bank for International Settlements is, in effect, acting as an agent for a group of foreign central banks of issue and therefore it is also appropriate to extend the exemption for bank-deposit interest to deposits of this bank.

(c) *Explanation of provision.*—In view of the considerations set forth above, the bill amends the code to exempt from U.S. tax interest received by foreign central banks of issue and the Bank for International Settlements from U.S. bank deposits unless the deposits are held in connection with commercial transactions of these banks. After 1971, this will distinguish their tax treatment for interest on bank deposits from that accorded other foreign persons.

(d) *Effective date.*—These amendments are effective with respect to taxable years beginning after December 31, 1966.

4. *Rules for determining the source of dividends from foreign corporations (sec. 2(b) of the bill and sec. 861(a)(2) (B) and (C) of the code)*

(a) *Present law.*—Present law provides that all or a portion of dividends paid by a foreign corporation to nonresident aliens or foreign corporations is considered to be from U.S. sources and therefore subject to U.S. tax, but only if 50 percent or more of the income of the foreign corporation making the distribution is derived from sources within the United States during the preceding 3-year period. This tax applies where the foreign corporation paying the dividend has itself usually already paid a U.S. tax on this same income when it received the income. The tax involved, therefore, is a second tax on the dividend distribution from the foreign corporation. The portion of the dividend treated as being from U.S. sources, where the 50-percent test referred to above is met, is the same proportion of the dividend which the gross income of the foreign corporation during the immediately prior 3-year period, from U.S. sources, is of its gross income from all sources for that period.

(b) *Reasons for provision.*—Your committee's bill restricts the likelihood of this tax being imposed. This tax on the dividends of foreign corporations has given rise to little in revenue in the past. On the other hand, elimination of the tax provision would give an unfair advantage to foreign corporations substantially all of whose business is conducted in the United States. Consequently, your committee's bill restricts the scope of this tax by modifying the applicable rule of present law in two respects. Under the amended provision, the tax will only apply if the foreign corporation is engaged in trade or business within the United States and even in the case of a corporation so engaged, it will only apply if 80 percent (rather than 50 percent) of its income is effectively connected² to the conduct of such business.

The increase in the percentage requirement from 50 to 80 percent gives assurance that the second tax on this dividend income, which is difficult to collect from nonresident aliens and foreign corporations, will be imposed only where U.S. operations account for the bulk of the income being paid out. The limitation to income which is effectively

² The term "effectively connected" is explained in No. B-2 below under sec. 2(d) of the bill.

connected with the conduct of a U.S. trade or business is in accord with the general concept, explained subsequently, of treating U.S. source investment income essentially the same with respect to foreign corporations whether or not they have a trade or business in the United States. As is explained further subsequently, different treatment with respect to this investment income does not appear appropriate merely on the grounds of the presence or absence in the United States of an unassociated trade or business of the foreign corporation.

(c) *Explanation of provision.*—To achieve the objectives set forth above your committee's bill amends the source rule with respect to dividends paid by foreign corporations to provide that no portion of a dividend received from a foreign corporation is to be considered to be from U.S. sources unless 80 percent or more of the corporation's gross income for the 3-year period preceding the year in which the dividend is declared, was effectively connected with the conduct of a trade or business in the United States. Thus, the effect of the interaction of these two rules is to decrease the portion of the dividends likely to remain subject to U.S. tax: this reduction occurs first because only income which is effectively connected to a U.S. trade or business is taken into account and, second, because, even with respect to such income, only if in the last 3-year period it accounted for 80 percent or more of the corporation's gross income.

The bill also contains a transitional rule providing that, in applying the new 80-percent test, all income derived from sources within the United States, and not merely that effectively connected to a trade or business in the United States, is to be taken into account for determinations made with respect to periods beginning before the effective date of these new provisions. Thus, any gross income of the foreign corporation from U.S. sources, for any period before the first taxable year beginning after December 31, 1966, is treated as effectively connected income in applying this test.

(d) *Effective date.*—These amendments are effective with respect to dividends received after December 31, 1966.

5. *Compensation for personal services (secs. 2 (c) and (d) of the bill and secs. 861(a) (3) (C) (ii) and 864(b) (1) of the code)*

(a) *Present law.*—Present law provides that payments of compensation for services performed in the United States generally are treated as U.S. source income. An exception to this rule is provided for compensation received by a nonresident alien where certain conditions are met. Thus, payments for personal services received by a nonresident alien are treated as foreign source income if (1) he was temporarily present in the United States for not over 90 days during the year; (2) the compensation does not exceed \$3,000; and (3) the services are performed for a foreign employer not engaged in a trade or business in the United States or for a domestic corporation if the services are performed for an office or place of business it maintains in a foreign country or U.S. possession. Also, present law provides that the rendering of personal services in the cases described above is not to constitute engaging in a trade or business in the United States.

(b) *Reasons for provision.*—Your committee's attention was called to the fact that temporary personal services of the type described above on occasion may be rendered not only for a domestic corporation hav-

ing an office or place of business abroad but also for a U.S. citizen, resident or for a domestic partnership where the citizen, resident or partnership has an office abroad. Your committee believes that the performance of temporary services in the United States subject to the same conditions as described above should be exempt from tax where the business abroad is that of a U.S. citizen, resident or partnership, just as it is in the case of a domestic corporation.

(c) *Explanation of provision.*—For the reasons given above, your committee's bill amends the source rule of present law relating to personal service income to provide that income from services performed by a nonresident alien temporarily present in the United States for not over 90 days in a year, if not in excess of \$3,000, is to be treated as foreign source income (and not subject to U.S. tax) not only in cases where the employer is a foreign person or a domestic corporation but also where the employer is a U.S. citizen or resident or a domestic partnership. Similar changes are also made in the definition of a "trade or business within the United States" to provide that this term does not include personal services performed for employers who are U.S. citizens or residents or for domestic partnerships where the conditions set forth above are met.

(d) *Effective date.*—These amendments are applicable with respect to taxable years beginning after December 31, 1966.

B. DEFINITIONS USED IN DETERMINING TAXABLE STATUS OF INCOME

1. *Trading in stocks or securities or in commodities (sec. 2(d) of the bill and sec. 864(b) (2) of the code)*

(a) *Present law.*—Present law specifically excludes from the activities which constitute engaging in a trade or business within the United States the trading activities conducted by a nonresident alien in stocks, securities, or commodities in the United States through a resident broker, commission agent, or custodian.

This rule also applies with respect to foreign corporations. However, a question has arisen whether a nonresident alien or foreign corporation is to be treated as carrying on a trade or business within the United States if the foreign person grants discretionary authority to a U.S. broker or other agent to carry out transactions in the United States with respect to his stocks, securities, or commodities. Under present law, the granting of this discretionary authority may prevent a nonresident alien or foreign corporation from qualifying for this exemption, with the result that income arising from these transactions and all other U.S. source income is subject to U.S. tax at the regular individual or corporate rates (based on a determination that such activities constitute carrying on a trade or business in the United States).

(b) *Reasons for provision.*—The granting of discretionary authority to a U.S. broker or agent is thought by many foreign investors to be a desirable protective device in the event they are not in a position to give buy or sell orders at any time and, in any event, such an arrangement is frequently the most convenient method of effecting stock, security, or commodity transactions. Moreover, the mere grant of this discretionary authority to a U.S. broker or agent would not appear to be significant enough to warrant treating the foreign per-

son acting on his own account as engaging in a trade or business here. Moreover, individuals who trade in U.S. stocks and commodities are not treated as thereby being engaged in the business of buying and selling stocks and commodities, whether or not the volume of their activity is large. Also, the confusion regarding the status of a foreign investor who has granted discretionary authority to a U.S. agent may have acted to deter some foreign investment in the United States.

(c) *Explanation of provision.*—For the above reasons your committee has amended present law to specifically provide that, except in the case of a dealer, the trading in stocks, securities, or commodities in the United States, for one's own account, whether by a foreign person physically present in the United States, through an employee located here, or through a resident broker, commission agent, custodian, or other agent—whether or not that agent has discretionary authority—does not constitute a trade or business in the United States. Although this treatment generally applies to foreign corporations as well as individuals, it generally does not apply in the case of a foreign investment corporation if it has its principal office here.

It is not intended that as a result of this provision a foreign investment company (other than a corporation which is, or but for section 542(c) (7) would be, a personal holding company) is to be permitted to locate its general business activities in the United States and avoid taxation at the regular corporate rates on its income and gains effectively connected with its business in this country. However, a foreign investment company conducting its general business activities in a foreign country (i.e., having its principal office there) can conduct trading activities in the United States through an agent with discretionary authority, without this giving rise to its being considered as conducting a trade or business in the United States.

Whether a corporation's principal office is in the United States is to be determined by comparing the activities (other than trading in securities) which the corporation conducts from an office located in the United States with the activities it conducts from offices located outside the United States. For example, a corporation which carries on most of its stock and securities transactions through an agent with discretionary authority in the United States but maintains a general business office outside the United States in which its management is located and from which it communicates with its shareholders and the general public, solicits sales of its own stock, and maintains its corporate records and books of account, would not be considered as having its principal office in the United States.

Although, under this provision, a dealer is specifically excluded from those who may grant discretionary authority and not be deemed to be conducting a business in the United States, he may trade in securities or commodities, for his own account, through a U.S. agent without being considered to be conducting a business in the United States. However, this rule does not apply if at any time during the year he has an office or place of business in the United States through which, or by the direction of which, transactions in stocks, securities, or commodities are effected.

Even though this provision does not free some dealers in stocks, securities, or commodities, and investment companies from the possi-

bility that they may be considered as engaged in a trade or business in the United States, this does not mean that all such dealers or investment companies are so engaged. Whether a dealer or investment company is conducting a trade or business in the United States remains a question of fact to be determined under the rules under present law.

(d) *Effective date.*—These amendments apply with respect to taxable years beginning after December 31, 1966.

2. *Income effectively connected with the conduct of a trade or business in the United States (sec. 2(d) of the bill and sec. 864(c) of the code)*

(a) *Present law.*—Under present law nonresident aliens and foreign corporations are generally taxable at the regular individual or corporate rates on all their U.S. source income if they are engaged in trade or business in the United States and are taxable at a flat 30-percent rate (or lower treaty rate) on all fixed or determinable income if not so engaged. This difference in treatment applies whether or not there is any relationship between the different types of income (business and investment) from the United States.

(b) *Reasons for provision.*—Under the rule described above, one foreigner may be taxed on investment income at the regular individual or corporate rates while another, with an identical portfolio investment, is taxed on his investment income at the flat 30-percent (or lower treaty) rate. The difference in treatment arises from the fact that one is engaged in business in the United States and the other is not, even though the investment portfolio of the former is wholly unrelated to his U.S. business. Your committee believes it is neither equitable nor logical for this substantial difference in tax treatment of investment income to depend on the presence or absence of an unrelated business. In addition, the Presidential Task Force on Promoting Increased Foreign Investment in U.S. Corporate Securities has pointed out that the present scheme deters foreign businessmen operating in the United States from investing in the United States, and also deters foreigners already investing in the United States from commencing a trade or business here.

The present scheme for taxing foreigners engaged in business in the United States also is defective in another respect. The interplay between the tax rules of certain foreign countries and the United States has in some cases permitted the use of the United States as a tax haven. The tax avoidance in such a case can be illustrated by a foreign corporation which is organized in a country which does not tax its domestic corporations on income derived from the conduct of a business outside the country. If such a corporation desires to sell products in countries, other than the United States or the country of its incorporation, it can, in many instances, avoid all or most taxation on the income from these sales by establishing a sales office in United States. The income from the sales in such cases is not taxed by the United States because (under the title passage rule) it is not derived from sources within the United States. The income may not be taxed by countries where the products are sold because the corporation does not have a permanent establishment there, and the income is not taxed by the country of incorporation because the business is not conducted there. Similar tax avoidance may be practiced in the case

of rents and royalties from a licensing business and income from banking, financing, or investment company business. Your committee believes that foreign corporations carrying on substantial activities in the United States, in such cases, should not be able to cast their transactions in such a form as to avoid both all U.S. tax and most foreign taxes. Also, it is believed that foreign corporations should pay a U.S. tax on the income generated from U.S. business activities.

To meet both types of problems described above your committee's bill provides for the taxation of nonresident aliens and foreign corporations at the regular U.S. graduated individual rates or corporate rates on their income which is effectively connected with the conduct of a trade or business within the United States. This effectively connected rule applies to all their income from sources in the United States and to three limited categories of foreign source income. The U.S. source income of nonresident aliens and foreign corporations which is not effectively connected with the conduct of a trade or business in the United States is taxed at a flat 30-percent rate (or reduced treaty rate).

(c) *Explanation of provision.*—As a general rule, the bill provides that income of a nonresident alien or foreign corporation will be subject to the flat 30-percent (or lower treaty) rate if it is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to income which is effectively connected to the conduct of a U.S. trade or business. However, the foreigner may elect to treat real property income as if it were income effectively connected with a U.S. business. This is to permit the deductions attributable to this real property income to be deducted from it. The application of the effectively connected concept to different types of income is set forth below.

(1) *Income from U.S. sources treated as "effectively connected."*—In determining whether periodical income such as interest, dividends, rents, wages, and capital gains is effectively connected with the conduct of a trade or business within the United States two principal factors are to be taken into account. First, is the income derived from assets used or held for use in the conduct of the trade or business in the United States? Thus, for example, are the assets being held for future, or remittant, use in the business? In this regard, particular attention will be given to the relationship between the asset and the needs of the business. Second, were the activities of the trade or business a material factor in the realization of the income? Thus, in the case of this second factor, is there an immediate relationship between the income in question and the U.S. business activities of the foreign corporation? Also to be taken into account in weighing the relationship of the investment income to the trade or business, but not to be a controlling factor by itself, is whether or not the assets or income are accounted for through the U.S. trade or business.

All other income from sources within the United States (that is, other than the periodical income and capital gains described above) is to be treated as "effectively connected" with the conduct of any trade or business within the United States.

(2) *Income from sources without the United States.*—Income from sources without the United States is not to be treated as "effectively connected" with the conduct of a trade or business within the United

States unless the nonresident alien or foreign corporation has a fixed place of business in the United States and the income, gain or loss is attributable to that place of business. Also, this provision applies to only three types of income from sources without the United States. A foreign corporation which to a minimal extent, or occasionally, uses the U.S. office of a related corporation will not thereby be treated as having a fixed place of business here. Moreover, the fact that top management decisions are made in the United States will not of itself mean that the foreign corporation has an office or fixed place of business here. For example, a foreign sales corporation which is a wholly owned subsidiary of a domestic corporation will not be considered to have a U.S. office because of the presence here of the officers of its domestic parent who are generally responsible only for its policy decisions, provided the foreign sales corporation has a managing director that conducts its day-to-day business from a foreign office. This person may or may not be an officer of the U.S. corporation. Also, in such a case, the managing director could regularly confer with the officers of the domestic parent and if necessary occasionally visit the U.S. offices of the domestic parent and, during such visits, temporarily conduct the business of the foreign subsidiary out of the domestic parent's office without thereby establishing a U.S. office.

As indicated above, this provision applies only to three specific types of income from without the United States and in no event applies with respect to income which is "subpart F" income or to dividend, interest or royalty income derived from a foreign corporation more than 50 percent owned by a nonresident alien or foreign corporation receiving the income. The three types of income with respect to which this provision applies are:

- (i) Rents and royalties derived from the active conduct of a licensing business;
- (ii) Dividends, interest, or gain from stock or bond or debt obligations derived in the active conduct of a banking, financing or similar business; and
- (iii) Certain sales income attributable to a U.S. sales office.

The sales income referred to above is not to be considered as "effectively connected" to a U.S. trade or business if the property is sold for use outside the United States and an office of the foreign person outside the United States contributes materially to the sale. Thus in this case foreign source sales income will be attributed to the U.S. trade or business only when the U.S. office is the primary place of the activity giving rise to the income. In the case of foreign source income where the products are destined for the United States, the income will be treated as effectively connected with a U.S. business to the extent the sales activity is carried on by the U.S. office.

The amount of income attributable to the U.S. sales office is not to be more than would have been attributable to it if the sale had been made in this country. This gives assurance, for example, that the sales income attributable to a U.S. business will not include income properly attributable to manufacturing or any other activities (apart from sales) occurring outside the United States.

In the case of a foreign corporation having a life insurance business in the United States, the bill provides that income from sources

without the United States will be treated as effectively connected with the conduct of the business within the United States if the income is attributable to its U.S. life insurance business. This rule merely continues the treatment which applies under existing regulations which provide that income of a foreign corporation from its U.S. life insurance business is subject to tax whether the income is from sources within or without the United States.

(d) *Effective date.*—This amendment applies with respect to taxable years beginning after December 31, 1966. For purposes of determining whether foreign source sales income from a binding contract, entered into on or before February 24, 1966, is attributable to a U.S. office, all the activities in the United States on or before that date, which were related to the negotiation or effectuation of the binding contract are not to be taken into account. As a result in many cases the sales income from foreign sources under binding contracts entered into before February 25, 1966, will not come within the ambit of this provision.

C. TAXATION OF NONRESIDENT ALIENS

1. *Income tax on nonresident alien individuals (sec. 3(a) of the bill and sec. 871 of the code)*

(a) *Present law.*—Present law provides different tax treatment for nonresident alien individuals according to whether they are, or are not, engaged in a trade or business in the United States. Also, those not engaged in a trade or business in the United States are provided different treatment according to whether their income is under or over \$21,200.

Nonresident alien individuals not engaged in trade or business in the United States whose annual U.S. source income of the types specified below is \$21,200 or less are taxed at a flat rate of 30 percent (or lower applicable treaty rate), on certain specified items of U.S. source income. This tax is in lieu of the regular U.S. graduated rates applicable to individuals. The items of income included are interest, dividends, rents, salaries, wages, and other fixed or determinable annual or periodical gains, profits, and income. Also specifically included in the income taxable at the flat 30-percent rate are certain amounts otherwise treated in the same manner as capital gains; namely, lump-sum distributions from exempt employees' trusts (sec. 402(a)(2)); amounts paid to beneficiaries under qualified annuity plans (sec. 403(a)(2)); timber, coal, and iron ore royalties (sec. 631 (b) and (c)); and amounts received on transfers of patent rights (sec. 1235).

Nonresident alien individuals not engaged in trade or business in the United States but with an annual U.S. source income of the types indicated above, of more than \$21,200, are taxed under present law (in the absence of an applicable treaty provision) at whichever of the following produces the higher total tax: the regular U.S. rates applicable to individuals, or the flat 30-percent rate. In computing the tax at the regular graduated rates, such a nonresident alien is allowed deductions to the extent they are properly allocable to the income on which he is taxable.

Nonresident aliens not engaged in a trade or business in the United States—whether their income is over or under \$21,200—are subject to tax on regular capital gains only if one of two conditions exists. They

are taxed on the gain, if they are physically present in the United States at the time the capital gain is realized. They also are taxed on the gain, whether or not present when it is realized, if they are present in the United States for a period or periods totaling 90 days or more during the year. These capital gains are taxed at the flat 30-percent rate, if the individual's income from U.S. sources is \$21,200 or less. If his income from U.S. sources exceeds this amount the regular capital gains tax rate will apply if the regular individual income tax rates (including the capital gains tax) on all the taxpayer's U.S. source income results in a higher tax than the flat 30-percent tax.

Nonresident alien individuals engaged in trade or business in the United States are taxable at the regular U.S. graduated (and capital gains) rates on their income derived from sources within the United States. In computing the tax, an alien in this category is allowed deductions to the extent attributable to his U.S. source income.

(b) *Reasons for provision.*—Your committee believes that the present tax treatment of nonresident aliens is unnecessarily complicated and also raises arbitrary distinctions based upon the size of the individual's income and whether or not the individual has a trade or business in the United States which may be wholly unrelated to the specific income in question. Your committee has retained the rule of present law which provides that U.S. trade or business income of nonresident aliens is subject to the regular individual income tax rates. However, other income is to be subject to the regular rates only if it is effectively connected with the U.S. trade or business. U.S.-source fixed or determinable income of nonresident aliens which is not so connected is to be subject to a flat 30-percent rate (or lower applicable treaty rate). This removes the arbitrary rule of present law which would vary the treatment of investment income, for example, depending upon whether the individual has an unrelated trade or business in the United States.

The flat 30-percent rate of tax in the case of certain nonresident aliens has been applied under present law, and is continued under the bill, because the United States does not have jurisdiction over all of such an individual's income. These taxpayers are not allowed the deductions that are available to U.S. citizens and the 30-percent rate is considered an appropriate effective rate in such cases. In addition, it has been found in practice that only a very small amount of tax has been collected as a result of imposing the graduated rates. It is also thought that applying the uniform flat rate with respect to income not effectively connected with a trade or business in the United States would tend to encourage investment here by foreigners. To the extent this occurs, there will, of course, be an improvement in our balance of payments.

In the case of capital gain, it was the opinion of your committee that the present rule that taxes a nonresident alien if present in the United States when the gain is realized is an arbitrary rule which constitutes only a trap for the unwary. Also, it was the committee's view that the exclusion for nonresident aliens not present in the United States for 90 days during a year should be extended to a period of 183 days. The 183-day period more closely parallels the general rule applied by most of the industrialized countries of the world.

(c) *Explanation of provision.*—For the reasons indicated above the bill substantially revises the income tax treatment of nonresident alien

individuals, dividing their income, for tax purposes, into two basic groups according to whether or not the income is effectively connected with a U.S. trade or business.

(1) *Income not effectively connected with the conduct of a U.S. business.*—Income of a nonresident alien individual which is fixed or determinable (substantially the same categories referred to under present law) and which is not effectively connected with the conduct of a trade or business in the United States is to be taxed at a flat 30-percent rate (or lower applicable treaty rate).

Generally, the fixed or determinable income referred to here, as under present law, includes such income as interest, dividends, rents, salaries, annuities, and certain income accorded capital gain treatment. In addition, however, your committee has added two items not included in the list contained in present law and has slightly modified the language of present law so as to clarify this provision as it relates to certain amounts received from pensions or annuity plans, certain timber, iron ore, and coal royalties, and gains on certain transfers of patent rights. The two new items added to the list are (1) gains with respect to the sale of stock of a collapsible corporation and (2) amounts received on retirement or exchange of bonds and other evidences of indebtedness issued after September 28, 1965, which are treated as gains from the sale of property which is not a capital asset. Under present law income of nonresident aliens of these two types may entirely avoid U.S. tax. Your committee believes that it is appropriate that this income be taxed in the case of nonresident alien individuals where it is derived from U.S. sources. In the case of original issue discount received on the retirement or sale or exchange of bonds the income is to be considered as having the same source as interest paid by the corporation issuing the bonds. As a result, if the corporation with respect to whose bonds the original issue discount arises is a domestic corporation which in the prior 3 years derives 80 percent or more of its income from foreign sources, then the original issue discount (interest) at the time of the retirement or sale or exchange of the bonds also will be considered as foreign source income.

In the case of a nonresident alien's net U.S. source capital gains (other than those specifically included in the list as taxable at the 30-percent rate) which are not effectively connected with the conduct of a trade or business within the United States, your committee's bill provides that no U.S. tax is to be imposed unless the nonresident alien has been present in the United States for at least 183 days during the taxable year. Present law provides a 90-day test. For purposes of applying the 183-day test an alien will be treated as being on a calendar year basis unless he has previously established a different taxable year. The requirement of present law which taxes capital gains when the alien is physically present in the United States at the time of realization is dropped entirely.

(2) *Income effectively connected with the conduct of U.S. business.*—Income of a nonresident alien individual that is effectively connected with the conduct of a trade or business in the United States, under your committee's bill is taxable at the regular U.S. graduated rates applicable to individuals. Thus, this income will be taxed the same as under existing law although the category itself is more limited

since it only applies to income which is effectively connected to a U.S. trade or business instead of including all U.S. source income of an alien with such a trade or business. For purposes of determining whether or not income is effectively connected with the conduct of a trade or business in the United States, the rules discussed above in connection with the definition of effectively connected income (No. 2, pt. B, above) apply.

(3) *Miscellaneous types of income receiving special treatment.*—Under present law certain types of income are provided special treatment. The bill revises and extends these categories as indicated below.

(i) *Participants in exchange programs.*—Your committee's bill retains the rule in present law which treats nonresident aliens temporarily in the United States as part of a cultural exchange or training program as engaged in a trade or business in the United States even though they are actually not so engaged. The provision is modified to provide in such cases that this type of income is effectively connected to a U.S. trade or business. The effect of treating these categories of income as effectively connected to a U.S. trade or business (or under present law as derived from a U.S. trade or business) is to impose the regular U.S. income tax on these aliens on the taxable portion of their scholarship or fellowship grants and certain other amounts incident to these grants. In this computation one exemption (except in the case of contiguous countries) and the deductions allocable to this income are allowed. In the absence of this special provision, these aliens would be taxed on these grants (and amounts incident thereto) at the flat 30 percent rate. In most cases the 30 percent tax would substantially exceed the regular tax on this income.

The types of income referred to under present law as scholarship or fellowship grants received by a nonresident alien individual temporarily present in the United States as a nonimmigrant (under subpar. (F) or (J) of sec. 101(a) (15) of the Immigration and Nationality Act) or received by a citizen or resident, are, subject to a dollar limitation, exempt from U.S. tax.

Present law (sec. 872(b) (3)) also excludes from gross income compensation paid by a foreign employer to a nonresident alien for the period he is temporarily present in the United States as a nonimmigrant for the purposes of participating in a cultural or training program. Under present law this is available where the "foreign employer" is a foreign person or a domestic corporation having an office in a foreign country or U.S. possession. The bill extends this to also cover a domestic partnership or a U.S. citizen or resident with such a foreign office.

(ii) *Income from real property.*—Under present law, it is not clear as to what situations or arrangements for the ownership by a nonresident alien of real property located in the United States will cause the nonresident alien to be considered as engaging in a trade or business within this country. This, of course, is important since the question of whether or not the alien is engaging in a trade or business in the United States determines whether his U.S. source capital gains are subject to U.S. tax and whether his other U.S. source income is taxable at the regular individual income rates, with allocable deduc-

tions, or at the flat 30-percent rate on the gross amount. Taxing income on real property at a flat 30-percent rate without the allowance of allocable deductions—which in the case of this type of income may be relatively large—may result in quite heavy tax burdens on this type of income. Your committee believes that the law in this area should be clarified and doubts whether the disallowance of deductions in such cases is appropriate. Moreover, the disallowance of deductions in such cases would tend to discourage foreign investment in U.S. realty.

The bill deals with the problem described above by providing that nonresident aliens deriving income from real property held for the production of income and located in this country, or from an interest in this type of real property located in this country, may elect to treat all the income as effectively connected to the conduct of a U.S. trade or business. This permits the nonresident alien to utilize the deductions attributable to this real estate income with the result that he is taxed on only his net income from these sources.

The election is applicable with respect to gains from the sale or exchange of real property held for the production of income (or an interest therein) and rents or royalties from mines, wells, or other natural deposits, as well as certain timber, iron ore, and coal royalties. The election is not applicable to income not specifically covered by these provisions, such as distributions by real estate investment trusts. If the election is made, it applies to all of the alien's income from this of U.S. real property for the taxable year which is not otherwise "effectively connected" with the conduct of a trade or business in this country. The election applies for all subsequent taxable years until revoked and can be revoked only with the consent of the Secretary of the Treasury or his delegate.

If the election is revoked, a new election may not be made for 4 years unless the Secretary of the Treasury or his delegate consents to an earlier reelection.

(iii) *Bond interest of residents of the Ryukyu Islands, etc.*—At the present time the Ryukyu Islands (including Okinawa) are governed by the United States and large numbers of the individuals of these islands are in the employ of the U.S. Military Establishment. As such, their savings have frequently been invested in series E or H U.S. savings bonds. Interest income on U.S. savings bonds is, of course, U.S. source income. As a result, under present law the residents of the Ryukyu Islands, as well as the Trust Territory of the Pacific Islands, are subject to a flat 30-percent tax on the income from these bonds. Since investment in U.S. savings bonds in their case is merely a convenient way for these individuals to save a portion of their income, it is difficult for them to see why a tax should be imposed any more than would be true if they were to invest their income, in the islands, in some other type of investment. Because of this, your committee's bill excludes from gross income subject to U.S. tax, income derived by nonresident aliens from U.S. savings bonds (series E or H) if the alien at the time of acquiring the bonds was a resident of the Ryukyu Islands or the Trust Territory of the Pacific Islands.

(d) *Effective date.*—These amendments apply with respect to taxable years beginning after December 31, 1966.

2. Deductions (sec. 3(c) of the bill and sec. 873 of the code)

(a) *Present law.*—In the case of a nonresident alien individual, present law generally allows deductions to the extent they are properly allocable to income from sources within the United States but only if the alien's U.S. income is subject to the regular income tax. However, where the regular income tax applies, the deduction of losses is allowed even though they are not connected with a U.S. trade or business if they are incurred in transactions entered into for profit provided that the transaction, had it resulted in a profit, would have been subject to U.S. tax. Also allowed are property losses not connected with a trade or business arising from certain casualties or thefts if the loss is of property located within the United States.

(b) *Explanation of provision.*—Your committee's bill amends present law generally to limit the allowance of deductions in case of a nonresident alien individual to deductions allocable to income which is effectively connected with the conduct of a trade or business in the United States. The allowance of deductions is limited in this manner, since it is only effectively connected income which under the bill is subject to the regular income tax.

In addition, the bill deletes the provision relating to the deduction of losses not connected with a trade or business but incurred in transactions entered into for profit since the criteria for the allowance of deductions under your committee's bill is whether or not they are effectively connected with the conduct of a trade or business in the United States. However, the casualty loss deduction is to be available even if the property which gives rise to the loss is not effectively connected with the conduct of a trade or business in the United States if the property is located in this country. Also, the charitable contribution deduction is available even though not related to the trade or business.

(c) *Effective date.*—These amendments apply with respect to taxable years beginning after December 31, 1966.

3. Expatriation to avoid tax (sec. 3(e) of the bill and new sec. 877 of the code)

(a) *Present law.*—The U.S. individual income tax applies to U.S. citizens, U.S. residents, and to nonresident aliens, but in this latter case, generally only with respect to income derived from sources within the United States. Under present law, if an individual who has been a U.S. citizen gives up this citizenship and becomes a nonresident, no tax is then imposed with respect to income he derives from sources without the United States. Moreover, under present law the regular graduated rates applicable to a citizen apply in the case of an expatriate, only if he is engaged in a trade or business in the United States or his income exceeds \$21,200.

(b) *Reasons for the provision.*—Your committee's bill by the elimination of progressive taxation with respect to the income of nonresident aliens which is not effectively connected with the conduct of a trade or business within the United States (as well as the reduction of the estate tax rates—described subsequently—applicable to the estates of nonresident aliens) may encourage some individuals to surrender their U.S. citizenship and move abroad. As indicated above,

by doing so an expatriate would avoid the graduated tax rates on his U.S. investment income (and in certain cases, avoid some estate taxes).

(c) *Explanation of provision.*—For the reasons stated above, the bill adds a new section to the code which, in general, taxes both effectively connected income and any other U.S. source income of an expatriate at regular income tax rates, if he lost his citizenship within five years of the taxable year in question (and after March 8, 1965) and if one of the principal purposes of the expatriation was the avoidance of U.S. income, estate, or gift taxes. This treatment is not to apply if it results in a smaller U.S. income tax than would otherwise be imposed.

In addition to imposing this tax on both the expatriate's U.S. source income not effectively connected with the conduct of a U.S. trade or business and his income that is "effectively connected" regardless of its source, the new section contains special source rules to be used in determining his U.S. source income. These rules provide that gains from the sale or exchange of property (other than stock or debt obligations) located in the United States, and gains on the sale or exchange of stock of a domestic corporation or debt obligations of U.S. persons or of the United States, a State or political subdivision, or the District of Columbia are to be treated as income from sources within the United States regardless of where the sale or exchange occurs or title is transferred. Deductions are to be allowed only to the extent they are properly allocable to the gross income of the expatriate, determined under the above described provisions (except that the capital loss carryover provision is not to apply).

The new section contains a special rule with respect to the burden of proving the existence or nonexistence of U.S. tax avoidance as one of the principal purposes of the expatriation. Under this provision, the Secretary of the Treasury or his delegate must establish that it is reasonable to believe that the expatriate's loss of U.S. citizenship would (but for the application of these special provisions) result in a substantial reduction in the taxes based on the expatriate's probable income for the taxable year.

If this is established, then the expatriate must carry the burden of proving that the loss of citizenship did not have, for one of its principal purposes, the avoidance of U.S. income, estate, or gift taxes. However, the new section excepts persons whose loss of citizenship occurs under circumstances where it is unlikely that tax avoidance was a principal purpose. For example, this provision does not apply where the person acquired dual citizenship at birth and loses his U.S. citizenship by residing, for a certain period, in the foreign country of which he is also a citizen by birth.

(d) *Effective date.*—This amendment applies for taxable years beginning after December 31, 1966.

4. *Partial exclusion of dividends from gross income (sec. 3(f) of the bill and sec. 116(d) of the code)*

Present law allows nonresident aliens the \$100 dividends received exclusion only if the individual is taxable on U.S. source dividends at the regular graduated rates applicable to individuals. Your committee's bill amends this provision, effective for taxable years beginning after December 31, 1966, to conform to the effectively connected in-

come concept by limiting the availability of the exclusion to dividends which are effectively connected with the conduct of a trade or business in the United States. The exclusion is also allowed in the case of an expatriate subject to tax (under new section 877).

5. *Withholding of tax on nonresident alien individuals (secs. 3(g) and (k) of the bill and secs. 1441 and 3401 of the code)*

(a) *Present law.*—Present law generally requires the withholding of tax in the case of a nonresident alien on U.S. source fixed or determinable income (of the types previously described). The withholding is at a 30-percent rate (except in the case of certain treaty rates) and applies whether or not the flat 30-percent tax applies to the individual.³ Thus it applies not only in the case of a nonresident alien with a gross income of \$21,200 or less who is not engaged in a trade or business in the United States but also in the case of a nonresident alien with a larger gross income and also to one who is engaged in a trade or business in the United States.

(b) *Reason for provision.*—Your committee believes that withholding at the 30-percent rate should only be required in the case of income which is taxed at that rate. Therefore, income which is effectively connected to the conduct of a U.S. trade or business should not be subject to this withholding tax at a 30-percent rate. This is particularly important in the case of compensation paid a nonresident alien. Unlike domestic wage withholding, this 30-percent withholding does not, in most cases, take into account the personal exemptions to which the worker would be entitled if he were a U.S. citizen. Also, since the regular graduated rates on small incomes are less than 30 percent, this rate may result in substantial overwithholding in many cases where regular income tax rates apply. Although an alien may obtain a refund of the excess withholding when he files his return at the end of the year, overwithholding in these circumstances can create a substantial hardship for the alien.

(c) *Explanation of provisions.*—To meet the problem outlined above, the bill adds a new provision to the existing nonresident alien withholding provisions. Under the new provision, withholding is not required on payments to nonresident alien individuals with respect to any item of income (other than compensation for services) which is effectively connected with the conduct of a trade or business within the United States. Additionally, no withholding is required in the case of amounts received on retirement or exchange of bonds issued after December 28, 1965, which are treated as gains from the sale of property which is not a capital asset or to gains with respect to the sale of stock of a collapsible corporation.

In the case of salary and wage income, the bill also correlates the 30-percent-withholding rate applicable to nonresident aliens with the domestic graduated withholding rates. Thus, the bill amends present law to provide that the Secretary of the Treasury or his delegate may, by regulations, exempt compensation for services performed by nonresident aliens from the 30-percent withholding. Also, to permit withholding at the domestic graduated withholding rates where an

³ For a limited category of scholarship and fellowship income and related income the withholding rate is 14 percent.

exemption is granted from the 30-percent-withholding provision, the bill amends the domestic wage withholding provisions to, in effect, permit the Secretary of the Treasury or his delegate to require withholding under those provisions.

The bill also makes amendments of a technical nature to conform the language of the withholding provisions to the language used in the taxing provisions.

(d) *Effective date.*—The amendment relating to the 30-percent withholding rule applies with respect to taxable years beginning after December 31, 1966. The amendment relating to domestic wage withholding applies with respect to remuneration paid after December 31, 1966.

6. *Withheld taxes and declarations of estimated income tax (secs. 3 (h) and (i) of the bill and secs. 1461 and 6015 of the code)*

Under present law, persons who are required to withhold on amounts paid to nonresident aliens and foreign corporations are required to file a return and remit the taxes withheld during any calendar year by March 15 of the following year. This procedure is unusual since all other withheld taxes, such as the employees' social security taxes and domestic wage withholding, are required to be remitted (together with the return) at least quarterly. As a result of the delay in the remittance of these 30-percent-withholding taxes, the withholding agents are given the use of these revenues for periods of time which are, in some case, more than one year.

Your committee sees no reason for not requiring the remittance of these tax revenues at a time period approximating that applicable in the case of domestic withholding. Therefore, your committee's bill amends present law to provide the Treasury Department with the authority to require more current remittance of the taxes withheld on nonresident aliens. This amendment is effective with respect to payments made after December 31, 1966.

Your committee's bill also amends the provisions of present law which require individuals to file declarations of estimated tax. The amendment continues present law which includes nonresident aliens within the category of individuals required to file these declarations. However, the application of this provision to nonresident aliens is limited to those who receive income which is effectively connected with the conduct of a trade or business within the United States.

These amendments are effective with respect to taxable years beginning after December 31, 1966.

7. *Gain from disposition of certain depreciable realty (sec. 3(j) of the bill and sec. 1250(d) of the code)*

(a) *Present law.*—Present law provides, in general, for the taxation of the gain on the sale or other disposition of depreciable real property as ordinary income rather than as capital gain, to the extent the gain is attributable to the allowance of depreciation deductions in excess of those that would have been allowed had the property been depreciated under the straight line method. This applies, however, only in the first 10 years during which a property is held and then to a lesser extent as the holding approaches the end of the 10-year period. This is commonly known as the real property recapture rule.

This rule is limited in the case of certain tax-free transfers so the amount taxed (recaptured) as ordinary income does not exceed the gain recognized on the transfer (generally the amount of the "boot"). Among the transfers to which this limitation applies are certain transfers to a corporation in exchange for its stock or securities.

(b) *Reason for provision.*—Under present law a foreigner may defeat the recapture provision by forming a domestic corporation and transferring the real estate with "excess depreciation" to the corporation solely in exchange for its stock. Thereafter, a nonresident alien can sell the stock outside the United States and thereby escape all U.S. tax liability on the sale. No U.S. tax applies in this case since the income from the sale of the stocks (outside the United States) is considered to be from sources outside the United States. Also, since all that was received in the earlier exchange of the real estate was stock, no tax applies on that transaction.

(c) *Explanation of provision.*—To prevent the tax avoidance referred to above the bill amends present law to provide that the recapture provision is to apply to a transfer of depreciated real estate by a foreigner to a domestic corporation in a tax free exchange for stock or securities in the domestic corporation.

(d) *Effective date.*—This amendment applies for taxable years beginning after December 31, 1966.

8. *Definition of foreign estate or trust (sec. 3(l) of the bill and sec. 7701(a)(31) of the code)*

Present law defines the terms "foreign trust" and "foreign estate" to mean a trust or estate, whose income from sources without the United States is not included in gross income for U.S. income tax purposes. The bill amends this definition to conform it to the effectively connected concept. As amended, the terms mean an estate or trust whose income from sources without the United States, which is not effectively connected with the conduct of a trade or business within the United States, is not included in gross income for U.S. income tax purposes. This amendment applies for taxable years beginning after December 31, 1966.

9. *Citizens of possessions of the United States (sec. 3(m) of the bill and sec. 932(a) of the code)*

Under present law, individuals who are citizens of possessions but not otherwise citizens of the U.S. are taxed as nonresident aliens on their U.S. source income. This provision is amended, effective for taxable years beginning after December 31, 1966, to conform to the changes made to the taxation of nonresident aliens generally.

D. TAXATION OF FOREIGN CORPORATIONS

1. *Income tax on foreign corporations (secs. 4 (a) and (b) of the bill and secs. 881 and 882 of the code)*

(a) *Present law.*—Present law taxes foreign corporations not engaged in a trade or business in the United States at a flat rate of 30 percent on fixed or determinable income from sources within the United States. These items are (with a few exceptions) the same as those presently taxed at the 30-percent rate to nonresident alien indi-

viduals not engaged in a trade or business in the United States. They are interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income (including certain timber, coal, and iron ore royalties).

The U.S. source income of a foreign corporation engaged in business in the United States is taxed, under present law, at the regular corporate rates. In computing the tax, deductions generally are allowed to the extent that they are properly allocable to the U.S. source income if a true and accurate return is filed by the corporation.

(b) *Reasons for provision.*—Your committee's bill, both in the case of nonresident aliens and in the case of foreign corporations, provides a consistent pattern of taxation. Nonresident aliens and foreign corporations will be taxed at the regular income tax rates in the case of income which is effectively connected with a U.S. trade or business. In the case of nonresident alien individuals and foreign corporations, with U.S. source fixed or determined income which is not effectively connected with a U.S. trade or business, a flat 30-percent rate is applied. The reasons for differentiating the tax treatment on this basis have already been explained to a substantial extent in connection with the definition of effectively connected (No. B-2, above) and in connection with the explanation of the taxation of nonresident aliens (No. C-1, above).

In the case of foreign corporations, this new classification of income—that effectively connected—probably represents less of a departure from the present tax treatment than in the case of nonresident alien individuals. One of the principal changes resulting from this new classification in the case of foreign corporations is that investment income which is not related to a trade or business carried on in the United States will be taxed at the flat 30-percent rate (or lower treaty rate) rather than at the regular corporate rate. This does away with the arbitrary distinction which exists under present law which makes the type of tax, a flat 30 percent or regular rate, turn on the presence or absence of a trade or business in the United States which may be wholly unrelated to the investment income.

Under the bill all U.S. source investment income (fixed or determinable) of foreign corporations not effectively connected with a trade or business in the United States will be taxed at a flat rate. However, all investment income effectively connected with a U.S. trade or business will be taxed in the same manner as other income of that trade or business, and in the same manner as similar income of a domestic corporation.

As indicated in connection with the definition of effectively connected the new rule for the taxation for foreign corporations will also prevent the use of the United States as a "tax haven" in the case of limited categories of foreign source income. However, these limited types of income do not, in any event, include "subpart F income" or, generally, income received from a foreign subsidiary.

This new rule for the taxation for foreign corporations should also tend to encourage foreign investment in the United States and thus is likely to have a favorable effect on the U.S. balance of payments.

(c) *Explanation of provision.*—The bill substantially revises the income tax treatment of foreign corporations. Under the bill the income of a foreign corporation is divided into two classifications.

(1) *Income not effectively connected.*—Fixed or determinable income of a foreign corporation from sources within the United States which is not effectively connected with the conduct of a trade or business within the United States, under your committee's bill, is taxable at a flat 30-percent rate (or lower treaty rate). The types of fixed or determinable income specified are the same as under present law with the same two additions provided in the case of nonresident aliens: (1) gains with respect to the sale of stock of a collapsible corporation, treated as ordinary income and (2) amounts of original issue discount which are treated as ordinary income received on retirement or sale or exchange of bonds or other evidences of indebtedness issued after September 28, 1965. As indicated in the case of the taxation of nonresident aliens, the source of this original issue discount is to be determined by the same rules as those applicable to interest income. As a result, if the corporation with respect to whose bonds the original issue discount arises is a domestic corporation which in the prior 3 years derives 80 percent or more of its income from foreign sources, then the original issue discount (interest), at the time of the retirement or sale or exchange of the bonds also will be considered as foreign source income.

Your committee has also clarified the language of present law which includes certain timber, coal, and iron ore royalties in the 30-percent list.

(2) *Income effectively connected.*—Income of a foreign corporation which is effectively connected with the conduct of a trade or business within the United States is taxable, under the bill, at the regular corporate income tax rates. In determining "taxable income" for this purpose, gross income includes only gross income that is "effectively connected" with the conduct of the trade or business within the United States.

(3) *Income from real property.*—Under present law (as explained with respect to nonresident alien individuals) it is not clear as to what situations or arrangements for the ownership by a foreign corporation of real property located in the United States will cause the foreign corporation to be considered as engaging in a trade or business within the United States. This is important to know because if a foreign corporation not engaged in a trade or business in the United States receives rents from U.S. real property, this rental income is taxable at the flat 30-percent rate (or applicable treaty rate) on the gross amount of such rents, without the allowance of any deductions attributable to the rental income. Consequently, the tax liability generated by this rental income may exceed the net rental income the corporation receives. Your committee believes that the law in this area should be clarified and doubts whether it is appropriate to tax the gross amount of this type of income.

Since the provisions of this amendment parallel the amendment provided in the case of real estate income of nonresident alien individuals, the explanation is not repeated here (see No. C-1(c)(3)(ii)).

(4) *Deductions.*—Under the bill, deductions are allowed in computing the tax imposed at the regular corporate rates only to the extent

that they are properly attributable to income which is effectively connected with the conduct of a trade or business within the United States. Charitable contributions, however, are allowed whether or not attributable to income which is effectively connected. As under present law, deductions are permitted only if a true and accurate income tax return is filed.

(d) *Effective date.*—These amendments apply with respect to taxable years beginning after December 31, 1966.

2. *Withholding of tax on foreign corporations (sec. 4(c) of the bill and sec. 1442 of the code)*

Under present law, the fixed or determinable U.S. source income of a foreign corporation not engaged in trade or business in the United States, like that of a nonresident alien not engaged in a trade or business in the United States, is subject to a withholding tax of 30 percent. However, foreign corporations engaged in trade or business in the United States are not subject to the withholding tax.

The bill amends the withholding provisions of present law to conform to the effectively connected concept in the bill. Thus, under the bill a withholding tax at the 30-percent rate will apply in the case of a foreign corporation to items of fixed or determinable U.S. source income which are not effectively connected with the conduct of a trade or business in the United States. The bill provides that this 30 percent withholding provision is not applied if the Secretary of the Treasury determines that the withholding requirements impose an undue administrative burden and that the collection of the tax will not be jeopardized by an exemption.

This latter point was added by your committee after its attention was called to the administrative difficulty foreign insurance companies would have in keeping dividend payors informed as to which investments are effectively connected with their U.S. business and which are not. In cases like this, if the Treasury concludes that revenue will not be jeopardized (or delayed) by foregoing withholding, your committee concluded it would be desirable to do so. This amendment is applicable to taxable years beginning after December 31, 1966.

3. *Deduction for dividends received from foreign corporations (sec. 4(d) of the bill and sec. 245(a) of the code)*

(a) *Present law.*—In general, present law allows an 85 percent dividend-received deduction for dividends received from domestic corporations. In order for this deduction to be available in the case of dividends from a foreign corporation, it must be engaged in a trade or business in the United States for an uninterrupted period of at least 3 years and 50 percent of its gross income must be from U.S. sources during that period. Where these conditions exist, an 85 percent dividend-received deduction is available for the same proportion of the dividend as the corporation's gross income, which is from U.S. sources, is of its total gross income.

(b) *Explanation of the provision.*—Your committee's bill conforms the dividends-received deduction to the effectively connected concept appearing elsewhere in the bill. Under the bill 50 percent or more of the foreign corporation's gross income for the uninterrupted period must be from income effectively connected with the conduct

of a trade or business within the United States for the deduction to be available. Also, the deduction is limited to 85 percent of the same proportion of the dividend as its gross income, which is effectively connected with a U.S. trade or business, is of the corporation's total gross income from all sources.

The bill also contains a transitional rule which makes it unnecessary to apply the effectively connected income concept when any of the years which are taken into account for the 50-percent test is a pre-1967 year. This rule provides that, for purposes of computing this deduction, all of a foreign corporation's U.S. source income, for any period, before the first taxable year beginning after December 31, 1966, is to be considered to be effectively connected income.

(c) *Effective date.*—These amendments apply for taxable years beginning after December 31, 1966.

4. *Unrelated business taxable income of certain foreign charitable organizations (sec. 4(e) of the bill and sec. 512(a) of the code)*

Under present law the unrelated business taxable income of foreign charities is subject to tax if it is derived from sources within the United States.

The bill conforms this provision to the effectively connected concept by providing that the unrelated business taxable income of a foreign charity is to be subject to tax only if it is effectively connected with the conduct of a trade or business in the United States.

This amendment applies for taxable years beginning after December 31, 1966.

5. *Corporations subject to personal holding company tax (sec. 4(f) of the bill and sec. 542(c) of the code)*

(a) *Present law.*—Under present law any foreign corporation with U.S. investment income, whether or not doing business here, may be taxed as a personal holding company unless all its outstanding stock is owned (directly or indirectly) by nonresident alien individuals and its U.S. source gross income is less than 50 percent of its total gross income for that year. If taxable as a personal holding company the foreign corporation is subject to a special 70 percent tax on its undistributed U.S. source personal holding company income in addition to the flat rate 30 percent tax (or possibly the regular corporate tax).

(b) *Reason for provision.*—The primary reason for applying the U.S. personal holding company tax to foreign corporations owned by nonresident aliens has been to prevent the avoidance of the graduated rates of U.S. tax applicable to certain nonresident alien individuals by utilizing foreign holding companies as the recipients of their U.S. source investment income. Generally the graduated rates presently apply when a nonresident alien's U.S. gross income exceeds \$21,200 or when he is engaged in a trade or business here. However, under your committee's bill nonresident aliens are not to be subject to the graduated rates of tax unless their income is effectively connected with a trade or business here. In view of this the retention of the personal holding company tax would appear to serve no purpose in those cases where all of the shareholders are nonresident aliens.

(c) *Explanation of provision.*—The bill deletes the provision in present law excluding from the personal holding company definition

only those foreign corporations where two tests are met; namely, where their U.S. source gross income is less than 50 percent of their total gross income and all of their stock is held directly or indirectly by non-resident aliens. In place of this the bill substitutes a broader exemption which applies to any foreign corporation all of whose outstanding stock during the last half of its taxable year is owned by nonresident alien individuals (directly or indirectly through foreign estates, trusts, partnerships or other foreign corporations).

(d) *Effective date.*—This amendment applies with respect to taxable years beginning after December 31, 1966.

6. *Foreign corporations carrying on insurance business in the United States (sec. 4(g) of the bill and secs. 819, 821, 822, 831, 832, 841, and 842 of the code)*

(a) *Present law.*—Present law taxes a foreign life insurance company carrying on a life insurance business in the United States on all its income attributable to that business in substantially the same manner as a domestic life insurance company.⁴ Foreign insurance companies carrying on life insurance businesses in the United States generally have interpreted this as providing they were not taxable on U.S. source income which is not income of the U.S. life insurance business of the company.

As is indicated above, with respect to their life insurance company business, foreign life insurance companies are taxed, under present law, in substantially the same manner as domestic life insurance companies. However, a special rule is provided where the surplus of a foreign life insurance company held in the United States is less than a specified minimum figure. This figure is expressed as the same percent of the foreign life insurance company's liabilities on U.S. business as the average surplus of domestic corporations is of their total liabilities. The Secretary of the Treasury determines this ratio each year. If the foreign insurance company's surplus held in the United States is less than this proportion of the taxpayer's total insurance liabilities on U.S. business, then the policy and other contract liability requirements, and the required interest for computing gain from operations, are reduced by this deficiency multiplied by the rate of earnings on investments. This provision is designed to prevent foreign insurance companies doing business in the United States from avoiding tax that they would otherwise have to pay to the United States merely by not holding a sufficient amount of surplus attributable to the U.S. business.

(b) *Reason for, and explanation of provisions.*—Your committee believes that foreign insurance companies—life insurance companies and other insurance companies, including both mutual and stock companies—should, in general, be taxed on their investment income in the same manner as other foreign corporations. For this reason, the bill provides that a foreign corporation carrying on an insurance business within the United States is to be taxable in the same manner as domestic companies carrying on a similar business with respect to its income which is effectively connected with the conduct of a trade or business

⁴ A foreign life insurance company that is not carrying on a life insurance business in the United States is taxable under the provisions applicable to foreign corporations generally.

within the United States. The remainder of the U.S. source income of this type of a corporation is to be taxed in the same manner as income of other foreign corporations which is not effectively connected to a U.S. trade or business; that is, at a flat 30 percent (or lower treaty) rate. The determination of whether a foreign insurance company qualifies for the special domestic insurance treatment is to be made by considering only the income of the corporation which is effectively connected with the conduct of its insurance business carried on in the United States. In making this change your committee intends no inferences as to the requirements of existing law with respect to investment income of foreign insurance companies.

For purposes of determining whether or not income of a foreign life insurance company is effectively connected with the conduct of its U.S. life insurance business, the annual statement of its U.S. business on the form approved by the National Association of Insurance Commissioners will usually be followed. It is noted that all the income effectively connected with the foreign life insurance company's U.S. life insurance business, from whatever source derived, comes within the ambit of this provision. This is a continuation of present law which subjects to U.S. tax all the income attributable to the U.S. life insurance business from whatever source derived.

In the case of insurance companies other than life—both mutual and stock—present law provides that if these companies have income from U.S. sources but are not engaged in an insurance business here, they are taxed in the same manner as other foreign corporations. Where mutual insurance companies (other than life or marine) are carrying on an insurance company business in the United States, they are taxable on their income derived from sources within the United States in the same manner as similar domestic mutual companies. Stock casualty, fire, flood, and so forth, insurance companies carrying on an insurance business in the United States, also are taxed in the same manner as domestic stock insurance companies with respect to the portion of their taxable income from sources within the United States.

It has been pointed out to your committee that the special rule in present law referred to above with respect to foreign life insurance companies—where these companies hold a lower ratio of surplus for their U.S. business than that held by the average domestic companies—may lead to what in effect is a double tax. This results from the interaction of this provision with the effectively connected rule. Thus for example, a company may find its deductions reduced (because of the minimum surplus requirement) while, at the same time, it is taxed at a flat 30 percent (or lower treaty rate) on investment income in this country not effectively connected with the U.S. business which, in effect, also includes the income subject to the minimum surplus adjustment.

To meet the problem referred to above, your committee has added a paragraph to the provision described above which has the effect of reducing the income subject to the flat 30-percent tax (or lower treaty rate) by the amount by which the deductions under this special provision are reduced as the result of the application of the Secretary's ratio. This is accomplished by allowing a credit against the 30-

percent tax (or lower treaty rate) for the tax levied on the hypothetical income attributed to the U.S. life insurance company business.

(c) *Effective date.*—These amendments apply with respect to taxable years beginning after December 31, 1966.

7. *Subpart F income (sec. 4(h) of the bill and sec. 952(b) of the code)*

(a) *Present law.*—Under present law certain portions of the undistributed income of a controlled foreign corporation are taxed currently to its U.S. shareholders having a 10 percent or greater voting interest. This undistributed income so taxed is termed “subpart F income.” In determining “subpart F income,” there is excluded income of a foreign corporation from U.S. sources which already is taxed by the United States because the corporation is engaged in trade or business in the United States. Present law is interpreted in the income tax regulations as not excluding from “subpart F” income, income exempt from U.S. tax, or subject to a reduced rate of tax, in accordance with a treaty.

Your committee’s bill modifies existing law to conform this provision with the effectively connected concept and to clarify the language of existing law with respect to income affected by treaties.

(b) *Explanation of provision.*—Your committee’s bill amends present law to provide that in determining “subpart F income” there is to be excluded only those items of income effectively connected with the conduct by the foreign corporation of a trade or business within the United States. It also makes it clear that “subpart F” income includes items exempt from U.S. tax or subject to a reduced rate pursuant to a treaty.

(c) *Effective date.*—This amendment applies with respect to taxable years beginning after December 31, 1966.

8. *Gain from certain sales or exchanges of stock in certain foreign corporations (sec. 4(i) of the bill and sec. 1248(d) of the code)*

(a) *Present law.*—Present law treats the gain realized by a 10-percent U.S. shareholder from the sale or exchange of stock of certain foreign corporations as a dividend, to the extent the post-1962 earnings and profits of the corporation are attributable to the shares being sold or exchanged. In determining the earnings and profits to be taken into account in determining this gain, present law excludes U.S. source income of a foreign corporation engaged in a U.S. trade or business. Consistent with the interpretation of similar language applicable to the determination of “subpart F income” explained above, these earnings and profits have been construed by the regulations as including income exempt from U.S. tax or subject to a reduced rate by treaty.

(b) *Explanation of provision.*—Your committee’s amendment provides that for years beginning on or after January 1, 1967, the earnings and profits of the foreign corporation (for purposes of sec. 1248) is not to include income effectively connected with the conduct of a trade or business within the United States. In addition, the amendment makes it clear that the exclusion does not apply to income which is exempt from tax, or subject to a reduced rate, pursuant to a treaty.

(c) *Effective date.*—This amendment applies to sales or exchanges occurring after December 31, 1966.

E. MISCELLANEOUS INCOME TAX PROVISIONS, ETC.

1. *Income affected by treaty (sec. 5(a) of the bill and sec. 894 of the code)*

(a) *Present law.*—Existing income tax treaties generally provide that the exemptions from tax, or the reduction in rates, provided for in its provisions apply only to persons who do not have a permanent establishment in the United States. The “permanent establishment” concept of the treaties serves a similar purpose as the “engaged in a trade or business in the United States” concept of U.S. tax law. The effect of such a provision in a treaty, therefore, is to deny the benefits of a treaty exemption or reduced rate to a nonresident alien individual, or a foreign corporation, engaged in a trade or business in the United States through a permanent establishment.

(b) *Explanation of provision.*—Under the tax treatment provided for such persons by your committee’s bill, the “engaged in trade or business in the United States” criteria is no longer the sole determinant of the method of taxing particular items of a nonresident alien individual’s, or a foreign corporation’s U.S. source income. Your committee’s bill seeks to tax all such persons alike on their noneffectively connected U.S. source income whether or not they also are engaged in a trade or business in the United States. This result would not be achieved under treaty provisions if some aliens or foreign corporations, because of having a permanent establishment in the United States, are denied the benefits of treaty rates or exemptions.

Your committee’s bill adds to the code a new subsection providing that for purposes of applying any exemption from, or any reduced rate of, tax granted by a 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 foreign corporation shall be deemed not to have a permanent establishment in the United States at any time during the taxable year. In other words, with respect to investment income not effectively connected to a trade or business, a nonresident alien or foreign corporation will be taxed at the lower treaty rate if one is provided. This provision does not apply in computing the special tax applicable to U.S. citizens who became expatriates with a primary purpose of avoiding tax.

(c) *Effective date.*—This new provision is effective for taxable years beginning after December 31, 1966.

2. *Application of pre-1967 income tax provisions (sec. 5(b) of the bill and new sec. 896 of the code)*

Unilaterally revising the statutory pattern of taxation of nonresident aliens and foreign corporations and granting favorable tax treatment to such persons may have the effect of making it more difficult to negotiate satisfactory tax treaties. At the same time, your committee believes that a systematic modernization of the U.S. income tax treatment of nonresident aliens and foreign corporations requires a modernization of the basic statutory provisions.

To prevent a deterioration in our position in negotiating treaties while at the same time modernizing these statutory provisions, your committee has added a provision to the tax laws which generally

grants to the President the authority to apply the income tax law without regard to the amendments which this or later acts make to the provisions relating to the taxation of foreigners (including corporations) in the case of any country which imposes more burdensome taxes on U.S. citizens and corporations than the United States does on nonresident aliens and foreign corporations.

The new section gives special authority to the President where he finds that—

(1) under the laws of any foreign country, citizens of the United States (not residents of the foreign country) or U.S. corporations are being subject to more burdensome taxes on any item of income from sources within the foreign country, than those imposed by the United States on similar U.S. source income of residents or corporations of the foreign country;

(2) when asked so to do the foreign country has not acted to revise or reduce its taxes to eliminate this condition; and

(3) it is in the public interest to reimpose the pre-1967 income tax provisions.

Where these conditions exist, the President may proclaim that the tax on similar income derived from U.S. sources by residents or corporations of the foreign country for taxable years beginning after the proclamation is to be determined by disregarding the amendments to the income tax law, as it relates to nonresident aliens and foreign corporations, made by this bill or by subsequent acts.

If after such a proclamation, the foreign country modifies the offending provisions of its tax law so that the President finds they are no longer more burdensome, he may proclaim that the U.S. tax on similar items of income derived from U.S. sources by residents or corporations of the foreign country, for taxable years beginning after such proclamation, is to be determined by taking into account the amendments made to the income tax provisions of the code relating to nonresident aliens and foreign corporations by this bill and later acts. Before the President makes a proclamation under this new provision, he is to give the Congress 30 days notice of his intention so to do.

(c) *Effective date.*—This provision is effective for taxable years beginning after December 31, 1966.

3. *Foreign community property income (sec. 5(e) of the bill and new sec. 981 of the code)*

(a) *Present law.*—The general income tax provisions provide, in effect, that the worldwide income of a U.S. citizen is subject to tax from whatever source derived. In a recent case,⁵ it was held that an American citizen who acquired residence in a foreign country with community property laws, and who married a nonresident alien, had a sufficient interest in one-half of the marital partnership income—even though earned by the husband foreigner—to render her subject to U.S. taxation on that income.

(b) *Reasons for provision.*—Your committee believes that it is undesirable to require a U.S. citizen to pay U.S. tax on income earned by a spouse who is a foreigner merely because of the attribution of one-half of the income to the U.S. citizen through the community

⁵ *Katrushka J. Parsons v. Commissioner*, 43 T.C. 331 (1964).

property laws of the foreign country of residence. Although the tax is levied on the spouse who is a U.S. citizen, it is regarded by most foreigners as a U.S. tax on the income from the labor and property of the foreigner spouse. In practice it appears that the revenue received from the application of this rule is limited because of the likelihood that persons subject to it are unaware of its existence. However, when a case is discovered, the tax liabilities are likely to be large because returns have not been filed.

An additional factor considered by your committee was that community property laws of foreign countries frequently make no difference in the source of taxable income since they often require joint returns by husbands and wives. Moreover, in many such countries it appears doubtful whether a U.S. wife under the law of that country could legally compel her foreigner husband to pay over to her amounts necessary to remit her U.S. tax liability on her community property income.

For the reasons given above, the bill provides a U.S. spouse with an election which would substantially negate the operation of the community property laws of the foreign country of residence.

(c) *Explanation of provisions.*—The bill provides elections to U.S. citizens who are, during the periods involved, married to nonresident aliens. If an election is made for post-1966 years, the community income of husband and wife are to be treated as follows:

(1) Earned income (sec. 911(b)) is to be treated as income of the spouse who rendered the personal services.

(2) Trade or business income is to be treated as income of the husband unless the wife exercises substantially all the management and control over the business. Also, a partner's distributive share of income is to be wholly attributed to him (same as self-employment rules under section 1402(a)(5)).

(3) Other community income which is derived from separate property of one spouse is to be treated as income of that spouse. What is "separate property" for this purpose is to be determined under the applicable foreign community property law.

(4) All other community income is to be treated as provided in applicable foreign community property law.

Due to the uncertainty in the tax treatment of this type of community property income in prior years, the election provided for pre-1967 years, to an even greater extent, ignores community property laws of the foreign countries. For pre-1967 years the treatment of income of the types set forth in categories (1), (2), and (3) above is to be the same as described above, but the income described in category (4) above is to be treated as income of the spouse who, for the year involved, had the greater amount of income described in (1), (2), and (3) plus separate income. Thus, category (4) income is attributed to the marital partner whose earnings or property were most likely to have given rise to this income.

For purposes of this provision, the treatment of deductions is to be compatible with that accorded the income to which the deductions are attributable. In other words deductions are to follow the income they generate.

This provision provides qualified taxpayers with two elections, one for pre-1967 years and one for future years. Either election can be

made for any year, at any time, so long as the year is still open. However, these elections are binding—if the election is exercised for any post-1967 year the treatment provided by this provision applies not only to the year of election but also to all years subsequent which are open and, if made for pre-1967 years, this provision applies for all open years prior to that date. It should be noted that either election can be made separately.

Generally, the election must be made by both spouses. However, with respect to the pre-1967 election, the foreigner spouse need not join if the Secretary of the Treasury determines that (1) an election would not affect the U.S. tax liability of the foreign spouse for any taxable year, or (2) that the foreign spouse's U.S. tax liability for pre-1967 years cannot be ascertained and that to deny the election to the U.S. citizen would be inequitable and cause undue hardship. If either election is made, a period of 1 year is provided with respect to all open years for the making of assessments and the claiming of refunds. However, this 1-year period applies only if the deficiency or refund is attributable to the election. Also, no interest is due on a deficiency or refund resulting from the election for any period up to 1 year after the filing of the election.

4. *Foreign tax credit (sec. 6(a) of the bill and secs. 874, 901, and new sec. 906 of the code)*

(a) *Present law.*—Present law allows a credit against U.S. income tax for foreign income, war profits, and excess profits taxes. However, this credit is denied to nonresident aliens and foreign corporations since under present law they are only taxable on their income from U.S. sources. This is consistent with the generally accepted concept that the country of the source has precedence in the taxing of income and that it should be the country of residence or citizenship which allows the credit to prevent double taxation.

(b) *Reasons for provision.*—As a result of the rule provided elsewhere in this bill nonresident aliens and foreign corporations, in certain types of cases, are taxable on foreign source income which is effectively connected with the conduct of a trade or business within the United States (see item B-2 above). In these cases the country of the source of the income may also impose a tax on this same income. Consistent with the general rule that taxes imposed by the country of source take precedence, your committee's bill provides that in any of these cases where the United States is taxing foreign source income of a nonresident alien or a foreign corporation, a foreign tax credit is to be available with respect to any income, war profits, and excess profits taxes also imposed on this same income by the country in which the income was earned.

(c) *Explanation of provision.*—For the reasons indicated above the bill adds a new section to the code (sec. 906) to allow a foreign tax credit to nonresident aliens and foreign corporations with respect to foreign source income which is subject to tax in the United States because it is effectively connected with the conduct of a trade or business in the United States. However, this foreign tax credit for nonresident aliens and foreign corporations is not to be available for taxes imposed by a country solely on the basis that it has jurisdiction to tax the individual on his or its worldwide income because he is a citizen or resi-

dent of that country or a corporation because it is created, incorporated or domiciled in that country. Precedence appropriately should not be given for such taxes because they are not imposed by the country which is the source of the income. In addition, these taxes, sometimes called residual taxes, are not to be deductible, whether or not the individual or corporation elects to take the foreign tax credit. The term "domiciled" for this purpose is intended to include any basis used by a foreign country for ascertaining jurisdiction (other than the source of the income) to tax a corporation on its worldwide income, such as the location of management and control of the corporation within the country.

The credit is allowed under the existing foreign tax credit provision and is subject to the existing "per-country" or "overall" limitations. The "per-country" limitation restricts the credit to the proportion of the U.S. tax which the taxpayer's taxable income from sources within the particular country bears to his entire taxable income for the year. Similarly the "overall" limitation restricts the credit to the proportion of the U.S. tax which the taxpayer's taxable income, from sources without the United States, bears to his entire taxable income for the year. In determining the credit allowable to a nonresident alien individual or a foreign corporation under these limitations, the individual's or corporation's taxable income is to include only the taxable income effectively connected with the taxpayer's conduct of a trade or business within the United States. Moreover, the credit is not allowable against U.S. taxes imposed at the flat 30-percent rate on income not effectively connected with the conduct of a trade or business in the United States.

Under some circumstances, present law treats a portion of the foreign taxes paid by certain foreign subsidiaries of a domestic corporation as having been paid by the domestic corporation for purposes of computing its foreign tax credit. Your committee's bill accords this same treatment to foreign corporations, but its application is limited to income effectively connected with the conduct of a trade or business within the United States.

(d) *Effective date.*—These amendments apply for taxable years beginning after December 31, 1966. In applying the foreign tax credit carryback and carryover provisions of present law to nonresident aliens and foreign corporations no amount may be carried to or from a taxable year beginning before January 1, 1967:

5. *Similar credit requirement (sec. 6(b) (2) and (3) of the bill and secs. 901(c) and 2014(b) of the code)*

(a) *Present law.*—Under present law, the foreign tax credit for income, etc., or death taxes are allowable to an alien who is a resident of the United States (or Puerto Rico) only if the foreign country of which the alien is a citizen or subject, in imposing its income, etc., or death taxes, allows a similar credit to citizens of the United States residing in such country.

(b) *Reason for provision.*—It has been called to the attention of your committee that present law acts to deny the credit to alien residents of the United States who are citizens of countries which may be following foreign policies which are adverse to the United States.

Such countries may be unconcerned as to our tax treatment of refugees from their country who become residents of the United States. The fact that the United States may deny a credit to refugees from their country, in fact, might encourage them not to provide a foreign tax credit or exemption in their laws for any residents of their country who may be U.S. citizens. Your committee believes that the denial of the credit to such persons under these circumstances is unjustified and, therefore, has amended present law so as to allow these persons the foreign tax credit unless the President finds that so doing is not in the public interest.

(c) *Explanation of provision.*—The bill modifies the provision of present law which in all cases denies a credit for citizens of a foreign country if it does not provide reciprocity for U.S. citizens residing there. Under the bill the President is given some discretion as to the disallowance of the credits in such cases. The bill provides that the President is to deny a foreign tax credit to residents who are subjects of a foreign country if he finds: (1) That a foreign country, in imposing income, war profits, and excess profits taxes or death taxes does not allow U.S. citizens residing in that country a credit for any taxes paid or accrued to the United States or any foreign country, similar to the foreign tax credit allowed by the United States to subjects of that foreign country residing in the United States, (2) that the foreign country, when requested to do so, has not acted to provide a similar credit to U.S. citizens residing in that foreign country, and (3) that it is in the public interest to allow the U.S. foreign tax credit to citizens or subjects of the foreign country who reside in the United States only if the foreign country allows such a similar credit to citizens of the United States residing in the foreign country.

The disallowance of the credit in any such case is to apply for taxable years beginning while a Presidential proclamation denying the credit is in effect.

6. *Overseas operations funding subsidiaries (sec. 6(c) of the bill and sec. 904(f) of the code)*

(a) *Present law.*—Generally, under present law the limitation on the allowable foreign tax credit, must be computed separately for all interest income and on a “per-country” basis. The exceptions to this general rule are for:

(1) Interest derived from any transactions directly related to the active conduct of a trade or business in a foreign country or U.S. possession;

(2) Interest derived in the conduct of a banking, financing, or similar business (such as an insurance company business);

(3) Interest received from a corporation in which the taxpayer owns at least 10 percent of the voting stock; and

(4) Interest received on obligations acquired as the result of disposition of a trade or business actively conducted by a taxpayer in a foreign country or as a result of a disposition of stock or obligations of a corporation in which the taxpayer owns at least 10 percent of the voting stock.

This provision was added to the code by the Revenue Act of 1962 so as to foreclose the transfer outside the United States (primarily

to Canada) of short-term funds, such as bank deposits, in order to make it possible to use foreign tax credits, which otherwise could not be used; to reduce the U.S. tax on a domestic corporations' worldwide income. Interest income previously could be used in this manner because typically the foreign tax on such income was below the regular corporate tax which would apply to interest income received by a domestic corporation. Thus, if the overall limitation were used there was foreign income which was available against which could be applied excess foreign tax credits.

(b) *Reasons for provision.*—U.S. corporations, in cooperating with the President's voluntary program to aid our balance of payments by limiting the outflow of capital investment funds, have been requested to obtain a portion of their funds necessary to finance their foreign operations from the foreign capital markets rather than from sources within the United States. In this manner, the flow of dollars abroad has been curtailed and our balance-of-payments position aided. Some corporations have established subsidiaries in this country for the specific purpose of handling these foreign funding transactions. However, the use of such a subsidiary to finance these foreign operations may result in the special separate interest income limitation (described above) being applied, for purposes of computing the foreign tax credit, with respect to interest income the subsidiary derives from loaning funds to the related companies.

As indicated previously an exception is provided in those cases where the U.S. taxpayer receiving the interest directly owns 10 percent of the foreign subsidiary paying the interest. However, where the U.S. parent establishes a wholly owned domestic subsidiary to borrow the foreign funds to finance the operation of its foreign subsidiary this exception of present law may not apply. This is because the funding subsidiary does not directly own a 10-percent interest in the foreign operating subsidiary. This is true even where the domestic funding subsidiary is a wholly owned subsidiary of a corporation which, in turn, owns more than 50 percent of the foreign operating subsidiary to whom the funds are loaned. In these circumstances your committee does not see why the limitation on the foreign tax credit should not apply in the same manner whether the foreign financing is done through the parent or a domestic subsidiary of the parent. Additionally, the application of the regular limitations, rather than the separate limitation on interest, in the case of these funding subsidiaries is particularly important now in view of their favorable impact on the balance of payments and the fact that they represent compliance with the administration's voluntary program for restraint on foreign investments. However, your committee did not wish this provision to be used to reduce U.S. taxes in transactions where debt obligations are not offered publicly, but instead to only a few large foreign investors.

(c) *Explanation of provision.*—This amendment provides that the limitation on the allowable foreign tax credit applicable to interest income is not to apply to a domestic funding subsidiary which was formed and availed of for the principal purpose of (1) raising funds outside the United States through foreign public offerings and (2) using these funds to finance the foreign operations of related foreign corporations.

For purposes of this provision the domestic funding subsidiary must be a member of the same affiliated group (meeting the 80 percent ownership tests of sec. 1504) as another domestic corporation and this affiliated group must own 50 percent or more of the voting stock of the foreign borrowing corporation either directly or through ownership of the stock of one other foreign corporation. This latter requirement, in effect, means that the borrowing subsidiary may be either a first or second tier foreign subsidiary.

(d) *Effective date.*—The amendments made by this provision apply to interest received after December 31, 1965, and in taxable years ending after that date.

7. Amendment to preserve existing law on deductions under section 931 (sec. 7 of the bill and sec. 931(d) of the code)

Under present law, U.S. citizens or domestic corporations earning income in possessions of the United States generally are taxable only on their U.S. source income (plus amounts received in the United States) if they meet certain requirements.⁶ In general, these requirements are that the citizen or corporation derive 80 percent of its gross income from sources within such a possession and 50 percent of its gross income from the active conduct of a trade or business within such a possession (both of these tests being applied with respect to income received in the prior 3 years).

A U.S. citizen or domestic corporation who qualifies for this treatment may exclude from his U.S. tax base gross income from sources without the United States (in the same way as nonresident aliens and foreign corporations not engaged in trade or business within the United States). The deductions allowed a U.S. person who qualifies for this exclusion are those which are allowable under present law to nonresident aliens and foreign corporations engaged in trade or business in the United States. In general, these deductions are: (1) Those connected with U.S. source income, (2) those allocated or apportioned under regulations with respect to deductions related to income which is partially from within and without the United States, (3) losses not connected with the trade or business but incurred in transactions entered into for profit (if the profit, had the transaction resulted in a profit, would have been taxable by the United States), (4) casualty losses (if the loss is of property within the United States), and (5) charitable contribution deductions.

Your committee's bill does not change the tax treatment of income qualifying for the exclusion relating to income from U.S. possessions but because it allows deductions to nonresident aliens and foreign corporations engaged in a trade or business in the United States only where the deductions are allocable to income effectively connected with this trade or business, it is now necessary in this provision to specify the deductions which may be taken. Your committee's bill therefore makes applicable to U.S. citizens and domestic corporations engaged in trade or business in possessions, who qualify for the special tax treatment under existing law, the provisions of present law which allow deductions to nonresident aliens or foreign corporations engaged in trade or business in the United States.

⁶ Possession for purposes of this provision does not include the Virgin Islands or, in the case of U.S. citizens does not include Puerto Rico.

This amendment is effective for taxable years beginning after December 31, 1966.

F. ESTATE TAX PROVISIONS

1. Estate tax rates (sec. 8(a) of the bill and sec. 2101(a) of the code)

(a) *Present law.*—The estate of a nonresident alien is taxed only on the transfer of property situated or deemed to be situated in the United States at the time of his death. While the tax rates are the same as for citizens and residents of the United States, the deductions, credits, and exemptions are different: No marital deduction is allowed with respect to the estate of a nonresident alien; the specific exemption in determining the taxable estate is \$2,000 instead of the \$60,000 applicable in the case of U.S. citizens; no credit is allowed for foreign death taxes paid; and expenses, losses, etc., are generally limited to the same proportion of these expenses which the alien's gross estate situated within the United States is of his entire gross estate.

(b) *Reason for provision.*—The fact that a marital deduction of up to 50 percent of the adjusted gross estate is not allowed in the case of the estate tax liability of a nonresident alien, in effect nearly doubles the size of the taxable estate of many aliens over that of similarly situated citizens. The \$2,000 exemption, instead of the \$60,000 exemption applying to citizens, also leads to a higher estate tax base. This, of course, means that the estate of a nonresident alien is likely to pay heavier taxes on its U.S. assets than would be true in the case of the estate of a U.S. citizen of similar size. Your committee believes that this is not appropriate. In addition it has been suggested to your committee that the high U.S. estate tax on the U.S. assets of a nonresident alien tends to discourage foreign persons from investing in the United States. Any increase in foreign investment in this country which may be brought about by this change will, of course, have a favorable effect on this country's balance of payments.

In view of the considerations set forth above, your committee believes that the taxation of the U.S. estates of nonresident aliens should be reduced to more closely equate with the taxation of the estates of U.S. citizens. The bill therefore establishes a new schedule of graduated estate tax rates applicable to nonresident aliens which will impose a tax on the U.S. estates of these persons in an amount which is generally equivalent to the tax imposed on an estate of similar value of a U.S. citizen with the maximum marital deduction. (As is explained subsequently the bill also increases the specific exemption available with respect to estates of nonresident aliens).

(c) *Explanation of provision.*—The new schedule of rates applicable to estates of nonresidents not citizens is as follows:

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 \$500,000----	\$5,000, plus 10 percent of excess over \$100,000.
Over \$500,000 but not over \$1,000,000----	\$45,000, plus 15 percent of excess over \$500,000.
Over \$1,000,000 but not over \$2,000,000--	\$120,000, plus 20 percent of excess over \$1,000,000.
Over \$2,000,000-----	\$320,000, plus 25 percent of excess over \$2,000,000.

Table 2 shows a comparison of the effective rates for estates of nonresident aliens provided by this new schedule with the effective rates under present law for nonresident aliens and U.S. citizens with and without a marital deduction. It will be noted that the effective rates resulting from the new schedule closely approximate those applicable in the case of the estate of a citizen with a marital deduction.

TABLE 2.—Effective rates of U.S. tax on U.S. estates of nonresident aliens under present law and under the bill and on U.S. citizens under present law

U.S. gross estate ¹	Effective rate of tax			
	Present treatment of nonresident alien	Tax treatment of nonresident alien provided by bill ²	U.S. citizen	
			With marital deduction	Without marital deduction
\$2,000.....				
\$10,000.....	2.9			
\$30,000.....	7.7			
\$60,000.....	12.5	2.0		
\$100,000.....	17.3	3.0		
\$500,000.....	25.8	7.4	8.0	3.0
\$1,000,000.....	28.8	10.1	11.1	22.1
\$5,000,000.....	43.0	17.8	16.9	26.7
\$10,000,000.....	53.3	20.6	21.2	42.3
				52.8

¹ For purposes of these computations it is assumed 10 percent of gross estate is deducted for funeral and other expenses both in the case of U.S. citizens and nonresident aliens.

² Takes into account the increase in the exemption from \$2,000 to \$30,000.

2. Limitation on credit for State death taxes (sec. 8(b) of the bill and sec. 2102 of the code)

(a) *Present law.*—Under present law, the estate of a nonresident alien is allowed a credit against its U.S. estate tax for death taxes it pays to any of the States of the United States. The only death tax some of the States impose is a so-called pickup tax, that is, a tax equal to the maximum credit for State death taxes allowable against the Federal estate tax. Other States impose a pickup tax in addition to their regular death taxes.

(b) *Reasons for provision.*—The credit for State death taxes in the Federal statute is based on the taxes actually paid to any State. At the same time the so-called pickup taxes ³ are designed to impose a sufficiently heavy tax on property within their jurisdiction to absorb any Federal tax with respect to which credit may be obtained. A problem arises from the interrelationship of these Federal and State rules where property, such as stocks, has a situs in the United States but for State death tax purposes is not considered to have a situs in any particular State—since the nonresident alien has no residence in any State. In such cases the effect of a State pickup tax may be to impose a disproportionately heavy State death tax on what may be the minor portion of the nonresident alien decedent's gross estate located there, in order to absorb the full Federal credit which may be available with respect to property, such as stocks, which have a U.S. situs

³ In addition to State pickup taxes, the problem here described may also arise where the State death tax with respect to the property located within its jurisdiction is heavier than the Federal estate tax with respect to such property.

but no situs in any particular State. Since the credit for death taxes was intended to be available with respect to death taxes, imposed at a level up to the Federal credit level, by States on property within their jurisdiction, it seems inappropriate to allow a credit for a State death tax at a rate above the Federal rate on the property merely on the grounds that there is other property subject to the Federal tax outside the jurisdiction of the State.

(c) *Explanation of provision.*—Your committee has amended present law to provide that the maximum credit for State death taxes allowable against the Federal estate tax imposed on estates of non-residents not citizens is to be an amount which bears the same ratio to the credit (computed without regard to this limitation) as the value of the property upon which the State death taxes are paid (and which is includible in the gross estate) bears to the total gross estate for Federal tax purposes.

(d) *Effective date.*—This amendment applies with respect to estates of decedents dying after the date of the enactment of this bill.

3. *Bond situs rule (sec. 8(c) of the bill and sec. 2104 of the code)*

(a) *Present law.*—Under present law, a nonresident alien is subject to the U.S. estate tax only with respect to property which is situated in the United States at the time of his death. The code provides so-called situs rules for determining under what conditions various types of property are to be considered as having a U.S. situs and therefore includible in the estate tax base of a decedent. Under these rules stock of a domestic corporation owned by a nonresident alien is considered to be property within the United States regardless of the location of the share certificates. In the case of bonds issued by U.S. corporations, no such statutory situs rule exists. Instead, for Federal estate tax purposes, the debt represented by a bond of a domestic corporation is considered to be situated at the location where the certificate is held. Other intangible debt obligations of U.S. obligors are treated as being situated within the United States.

(b) *Reasons for provision.*—The difference in treatment for bonds is based upon the view that bonds constitute the debt itself and hence the debt is situated with the bonds, but with respect to other obligations the written statement of the obligation is only evidence of the existence of the debt and hence the debt is situated with the debtor. Your committee believes that this distinction is an unsatisfactory basis for exempting these bonds from the U.S. estate tax. Moreover, it sees no reason for treating bonds and stock differently in this respect.

(c) *Explanation of provision.*—For the reasons given above your committee's bill adds a new provision to the law providing that for purposes of the tax imposed on the estates of nonresidents not citizens, all debt obligations (including bonds) of a U.S. person, the United States, a State or political subdivision of a State, or of the District of Columbia owned by a nonresident not a citizen of the United States are to be deemed to be property situated within the United States. An exception to this rule is provided for debt obligations of U.S. corporations which have derived less than 20 percent of their gross income from U.S. sources for the 3 years prior to the nonresident's death. In such cases these debt obligations are to be considered as

having a foreign situs. For purposes of this provision U.S. currency is not to be considered a debt obligation of the United States.

(d) *Effective date.*—This amendment applies with respect to estates of decedents dying after the date of enactment of this bill.

4. *Deposits in U.S. banks or foreign branch banks of U.S. corporations (sec. 8(d) of the bill and sec. 2105 of the code)*

(a) *Present law.*—Present law provides that, for purposes of estate tax, the deposits of nonresident aliens with U.S. persons carrying on the banking business will not be considered to have a situs within the United States if the decedent was not engaged in a trade or business in the United States at the time of his death and a situs within the United States if the decedent was so engaged. This rule applies to deposits in foreign branch banks of U.S. corporations as well as to deposits in domestic banks.

(b) *Reasons for provision.*—As explained above with respect to the rules for determining the source of interest payments on bank deposits with U.S. banks (see No. A-1 above), your committee believes that it is questionable whether deposits of this type which are clearly situated in the United States should be treated as though situated without the United States and thereby allowed to escape U.S. estate taxation. On the other hand, deposits in foreign branch banks of U.S. corporations are, in fact, situated in a foreign country. Additionally, with respect to deposits in foreign branch banks of U.S. corporations, it is understood that foreign persons often have been uncertain as to whether they would be held to be “engaged in business in the United States” and that as a result they have been reluctant to deposit their funds in foreign branch banks of U.S. corporations for fear this might subject their estate to U.S. tax. As a result they are likely to place their deposits in competing foreign banks. Thus the present treatment clearly discriminates against the U.S. branches and adversely affects their ability to compete in foreign countries.

(c) *Explanation of provision.*—Your committee, for the reasons given above, has deleted the provision of present law which treats U.S. bank deposits of a nonresident alien as situated without the United States. Additionally, the bill adds to the code a new provision which deems the situs of deposits by foreigners in foreign branch banks of U.S. corporations to be without the United States. The new situs rule provides that for purposes of the U.S. estate tax on estates of nonresident aliens, deposits in a foreign branch bank of a U.S. corporation, if the branch is engaged in the commercial banking business, are not to be deemed to be property within the United States. Therefore these deposits will not be included in the foreigner’s taxable U.S. estate.

(d) *Effective date.*—This amendment is applicable to the estates of decedents dying after the effective date of this act.

5. *Definition of taxable estate (sec. 8(e) of the bill and sec. 2106(a) (3) of the code)*

(a) *Present law.*—Under present estate tax law, the estate of a citizen of the United States is entitled to a \$60,000 exemption. In the case of the estate of a nonresident alien, however, present law allows only a \$2,000 exemption. In the case of decedents who were residents

of U.S. possessions at the time of death and are citizens of the United States solely by reason of being a citizen of the possession, or by reason of birth or residence in the possession, the exemption is the greater of \$2,000, or the proportion of the \$60,000 exemption granted to U.S. citizens which the value of that part of the decedent's gross estate which is situated in the United States bears to the value of his entire gross estate.

(b) *Reason for provision.*—Presumably the basis for having a lower exemption for nonresident aliens than citizens and residents is that they typically have only a portion of their estate in the United States and therefore should have only a portion of the exemption allowed citizens and residents. Your committee also agrees that this justifies a lesser exemption for nonresident aliens but the minimal estate tax exemption presently allowed is so low as to place an unreasonable and inequitable tax burden on the estates of nonresident aliens. The exemption level your committee concluded was reasonable for nonresident aliens was \$30,000, or half that allowed in the case of citizens. This is high enough to make filing of returns unnecessary in the case of relatively small investments here. This level of exemption was also selected in conjunction with the rates made applicable to nonresident aliens (see No. F-1 above) to assure approximately the same level of tax burdens for a nonresident alien as in the case of citizens of the United States eligible for the marital deduction.

(c) *Explanation of provision.*—The bill amends the code to provide that the estate of a nonresident not a citizen is allowed to deduct a \$30,000 exemption in computing the taxable estate. The exemption which the estate of a resident of a U.S. possession to which the special rule applies is allowed, under your committee's amendment, is to be the greater of \$30,000 or the proportion of the \$60,000 exemption allowable under present law.

(d) *Effective date.*—These amendments apply to estates of decedents dying after the effective date of this act.

6. *Expatriation to avoid tax (sec. 8(f) of the bill and new sec. 2107 of the code)*

(a) *Present law.*—The U.S. estate tax applies to U.S. citizens and U.S. residents with respect to their estate no matter where situated. However, a foreign estate tax credit is allowable with respect to foreign death taxes paid in the case of property having a situs outside of the United States. In the case of nonresident aliens, a U.S. estate tax also applies but only with respect to property having a U.S. situs. Under present law, if an individual who has been a U.S. citizen gives up this citizenship and becomes a nonresident alien, no tax is imposed with respect to his estate to the extent the property is situated outside of the United States.

(b) *Reason for provision.*—As discussed above with respect to the income tax provision of this bill, your committee is concerned that the elimination of the progressive income tax rates on income of nonresident aliens which is not effectively connected with a U.S. trade or business may encourage some U.S. citizens to surrender their U.S. citizenship and move abroad. Accordingly, the bill contains a provision which generally has the effect of retaining the progressive

income tax rates for a period of 5 years in case of persons who become expatriates where it appears likely that they did so for tax avoidance purposes. The same problem exists as a result of the reduction of the estate tax rates applicable to nonresident aliens. Although it is doubtful that many citizens would expatriate for this reason, your committee believes that the removal of any such incentive is desirable. In these cases the wealth of the expatriate generally would have been accumulated in the United States and therefore is properly subject to the regular U.S. estate tax rates.

(c) *Explanation of provision.*—For this reason, the bill adds a new section to the code which imposes the regular U.S. estate tax rates on the U.S. estate of a nonresident alien dying within 10 years after losing U.S. citizenship if one of the principal purposes of the loss of citizenship was the avoidance of U.S. income, estate, or gift taxes. This provision is not to apply to those who lost their citizenship before March 8, 1965 (the date of introduction of a predecessor bill, H.R. 5916, on this topic). It also does not apply in the case of decedents dying before the date of enactment of this bill.

In determining the value of the gross estate of such an expatriate (as in the case of nonresident aliens generally) only property situated in the United States that was owned by him at the time of his death is included. However, the U.S. estate tax base of these expatriate decedents is expanded in certain respects to prevent him from avoiding U.S. tax on his estate by transferring assets with a U.S. situs to a foreign corporation in exchange for its stock. Such a transfer by a nonresident alien would reduce the portion of his gross estate having a U.S. situs, since the stock of a foreign corporation has a foreign situs even though the assets of the foreign corporation are situated in the United States. The new provision specifies, if certain stock ownership tests are met, that the value of the expatriate's gross U.S. estate is to include the same proportion of the value of the stockholdings of the expatriate in the foreign corporation as its property having a U.S. situs bears to all its property.

The ownership tests that must be met for this special provision to apply are:

(i) The decedent must have owned at the time of his death 10 percent or more of the voting power of all classes of stock of the foreign corporation. Ownership for this test includes direct ownership and indirect ownership through another foreign corporation or through a foreign partnership, trust, or estate.

(ii) The decedent must have owned, at the time of his death, 50 percent or more of the total voting power of all classes of stock of the foreign corporation. Ownership for purposes of this test is ownership as described in (i) above plus ownership attributed to the expatriate under certain attribution rules of existing law (sec. 318 of the code). In general, these rules attribute to an individual ownership of stock held by members of his family, as well as by partnerships, trusts, estates, or corporations in which the individual has certain interests.

In addition, in determining whether the ownership tests are met, and in determining the portion of the U.S. situs property owned by the foreign corporation that must be included in computing the value of

his gross estate, the expatriate is treated as owning the stock of a foreign corporation (at the time of his death) which he transferred during his life but which under U.S. estate tax law generally is not effective in excluding property from a gross estate. There transfers are:

- (i) Transfers in contemplation of death (sec. 2035).
- (ii) Transfers with retained life estate (sec. 2036).
- (iii) Transfers taking effect at death (sec. 2037).
- (iv) Revocable transfers (see 2038).

In computing the estate tax under this new provision the expatriate's estate is allowed the credit for State death taxes, the credit for gift tax, and the credit for tax on prior transfers.

The new section excepts from its application certain expatriates whose loss of U.S. citizenship occurs under circumstances which would make the application of the special taxing provisions inappropriate. These are the same exceptions provided with respect to the income tax expatriation provision (see No. C-3 above).

The new provision, like the comparable income tax provision, contains a special rule dealing with the burden of proving the existence or nonexistence of U.S. tax avoidance as one of the principal purposes of the expatriation. Under this provision, the Secretary of the Treasury or his delegate must establish that it is reasonable to believe that the expatriate's loss of U.S. citizenship would (but for the application of this new provision) result in a substantial reduction in the estate, inheritance, legacy, and succession taxes.

If this is established, then the administrator of the expatriate's estate must carry the burden of proving that the loss of citizenship did not have as one of its principal purposes the avoidance of U.S. income, estate, and gift taxes.

(d) *Effective date.*—This new provision is effective with respect to estates of decedents dying after the date of enactment of this bill. It does not, in any event, apply, however, to expatriates who lost their citizenship before March 8, 1965.

7. *Application of pre-1967 estate tax provisions (sec. 8(f) of the bill and new sec. 2108 of the code)*

The unilateral reduction of estate tax rates applicable to nonresident aliens by statute may have the effect of making it more difficult to negotiate estate tax treaties. This is comparable to the similar problem arising from the revision of the income tax provisions applicable to nonresident aliens. As in the case of the income tax provisions therefore, your committee has added a new provision which gives authority to the President to apply certain provisions of the estate tax law relating to estates of nonresidents not citizens, without regard to the amendments made to these provisions by this, or any subsequent, act in the case of estates of residents of any country which imposes more burdensome estate taxes with respect to estates of U.S. citizen decedents, not residents of that country, than does the United States on estates of residents of such a country, not citizens of the United States.

The new provision gives special authority to the President where he finds that:

- (a) Under the laws of a foreign country a more burdensome tax is imposed on the estates of U.S. citizens, not residents of the

country, than is imposed on the estates of residents of that country by the United States;

(b) The foreign country, when requested so to do, has not revised its taxes to eliminate this extra burden; and

(c) It is in the public interest to reimpose the pre-1967 estate tax provisions.

Where these conditions exist the President may proclaim that the U.S. tax on estates of residents of the foreign country is to be determined under certain provisions of U.S. estate tax laws (secs. 2101, 2102, 2106, and 6018) as in effect prior to amendment by this or any subsequent act. Such a proclamation is to apply to the estates of decedents dying after the date of the proclamation.

If after making such a proclamation the President finds that the laws of the foreign country have been revised to alleviate the excess burden on the estates of U.S. citizens he may proclaim that the tax on the estates of residents of the country is to be determined by taking into account the amendments made by this bill, and any subsequent act. Such a proclamation is to be effective with respect to estates of decedents dying after its date.

Before issuing a proclamation under the new provision the President is required to give 30 days notice of his intent so to do to the Senate and the House of Representatives.

This new section is applicable with respect to estates of decedents dying after the date of the enactment of this bill.

8. Estate tax returns (sec. 8(g) of the bill and sec. 6018 of the code)

Under present law the executor of the estate of a nonresident alien is required to file a U.S. estate tax return if the U.S. estate exceeds \$2,000. The filing of returns with respect to these estates of over \$2,000 is required because only a \$2,000 exemption is granted to the estates of nonresident aliens under present law. Since your committee's bill has increased the \$2,000 exemption to \$30,000, the return filing requirement is likewise increased by the bill from \$2,000 to \$30,000. This amendment applies with respect to estates of decedents dying after the enactment of this bill.

G. GIFT TAX PROVISIONS

1. Tax on gifts of nonresidents not citizens (sec. 9(a) of the bill and sec. 2501 of the code)

Under present law a gift of intangible property having a U.S. situs by a nonresident alien who is engaged in trade or business in the United States is subject to U.S. gift tax.

In practice this rule has proved to be impossible to enforce, since there is no practical way for the Internal Revenue Service to find out when these gifts are made. Moreover, it does not occur to many nonresident aliens that these transfers are subject to U.S. gift tax. Thus the revenue significance of this provision is minimal.

For the above reasons your committee's bill amends present law to provide that gifts of intangible property by nonresident aliens are not to be subject to the U.S. gift tax.

To prevent this new rule from becoming a means of tax avoidance by U.S. citizens, the bill also provides that the rule is not to apply to

gifts by donors who within the 10 years immediately before the date of the gift became expatriates of the United States with a principal purpose of avoiding U.S. income, estate, or gift taxes.

As in the case of similar amendments made by your committee with respect to the income and estate taxes, the new provision provides a special rule relating to the burden of proof. Under this rule if the Secretary of the Treasury or his delegate establishes that it is reasonable to believe that the individual's loss of U.S. citizenship will result in a substantial reduction in the gift tax payable by the donor, the burden of proving that tax avoidance was not one of the principal purposes rests with the donor. Certain types of losses of citizenship, as in the case of similar income and estate tax provisions, are not to result in the application of this provision (see No. C-3 above).

This amendment applies with respect to the calendar year 1967 and all calendar years thereafter.

2. *Situs of bonds given by expatriates (sec. 9(b) of the bill and sec. 2511 of the code)*

Under present law bonds issued by U.S. persons, unlike other debt obligations, are considered to be situated where the instrument is located for purposes of the gift tax applicable to nonresident aliens. Under this rule (and in the absence of the provision added here) a person who becomes an expatriate with a principal purpose of avoiding U.S. taxes would continue to escape U.S. gift taxation (even under the special gift tax rules this bill makes applicable to them) on the transfer of a debt obligation of a U.S. person. To prevent this result, your committee's bill amends the present gift tax laws to provide that debt obligations of a U.S. person, or of the United States, a State or political subdivision thereof, or the District of Columbia which are owned by nonresident aliens are deemed to be situated in the United States. This amendment applies with respect to the calendar year 1967 and all calendar years thereafter.

H. TREATY OBLIGATIONS

The bill provides that no amendment made by this bill is to apply in any case where its application would be contrary to any treaty obligation of the United States. However, for purposes of this provision, the granting of a benefit provided by any amendment made by this bill will not be considered to be contrary to a treaty obligation.

V. TECHNICAL EXPLANATION

SECTION 1 OF BILL. SHORT TITLE, ETC.

(a) *Short title.*—Subsection (a) of section 1 of the bill provides that the bill may be cited as the "Foreign Investors Tax Act of 1966."

(b) *Table of contents.*—Subsection (b) of section 1 of the bill contains a table of contents of the sections of the bill.

(c) *Amendment of 1954 code.*—Subsection (c) of section 1 of the bill provides that, except as otherwise expressly provided, whenever in the bill 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.

SECTION 2 OF BILL. SOURCE OF INCOME

(a) *Interest.*—Subsection (a) of section 2 of the bill amends section 861 of the code (relating to income from sources within the United States) in its application to interest income and section 895 of the code (relating to income derived by a foreign central bank of issue from obligations of the United States).

Certain interest not treated as income from sources within the United States

Existing section 861(a) (1) provides generally that interest paid by a resident of the United States, corporate or otherwise, is income from sources within the United States. Subparagraph (A) of section 861(a) (1) excepts interest paid on deposits with persons carrying on the banking business from this rule if such interest is paid to persons not engaged in business in the United States.

Paragraph (1) (A) of section 2(a) of the bill revises existing subparagraph (A) of section 861(a) (1) to provide in effect that interest on the amounts described in new subsection (c) of section 861, as added by paragraph (1) (B) of section 2(a) of the bill, is not considered income from sources within the United States if such interest is paid (or credited) to a nonresident alien individual or foreign corporation before January 1, 1972, and such interest is not effectively connected with the conduct of a trade or business within the United States by such recipient. The amendment of section 861(a) (1) (A) is effective for taxable years beginning after December 31, 1966, but such section shall cease to apply in the case of amounts paid or credited after December 31, 1971.

Paragraph (1) (B) of section 2(a) of the bill amends section 861 of the code by adding a new subsection (c) which describes the amounts the interest on which is subject to the source rule of new section 861(a) (1) (A). The amounts so described are (1) deposits with persons carrying on the banking business (including certificates of deposit); (2) deposits or withdrawable accounts with mutual savings banks, cooperative banks, domestic building and loan associations, and other savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law, but only to the extent that the amounts paid or credited on such deposits or accounts (in respect of which a determination is being made under sec. 861(a) (1)) are of a type which are deductible under section 591 of the code (relating to deductions for dividends paid on deposits) in computing the taxable income of such institutions; and (3) amounts held by an insurance company under an agreement to pay interest thereon. New section 861(c) is effective for taxable years beginning after December 31, 1966.

The rule in existing section 861(a) (1) (A) with respect to interest on bank deposits has been revised in amended section 861(a) (1) (A) so as to apply only if the interest is not effectively connected with the conduct of a trade or business within the United States and only when received by a nonresident alien individual or a foreign corporation.

Deposits and withdrawable accounts with savings and loan or similar associations are included in new section 861(c) (2) so that interest (and so-called dividends) paid on such deposits or withdrawable

accounts are treated in the same manner as interest on bank deposits. Under section 591 of the code amounts paid to, or credited to the accounts of, depositors or holders of accounts as dividends or interest on their deposits or withdrawable accounts are deductible by the association if the depositor or holder of account is entitled to withdraw such amounts on demand, subject to customary notice of intention to withdraw. The provisions of amended section 861(a)(1)(A) do not apply to amounts paid by such savings and loan or similar associations on or with respect to shares of capital stock of such associations, or on or with respect to funds held in restricted accounts which represent a proprietary interest in such associations.

Interest on amounts held by insurance companies under an agreement to pay interest thereon is also subject to the provisions of amended section 861(a)(1)(A). In determining under new section 861(c)(3) whether an amount is held by an insurance company under an agreement to pay interest thereon the same rules are to apply as are applied under section 6049(b)(1)(D) of the code (relating to returns regarding payments of interest). Thus, for example, the provisions of amended section 861(a)(1)(A) apply to interest paid on policy "dividend" accumulations and interest paid with respect to the proceeds of insurance policies left with the insurer. The so-called interest element in the case of annuity or installment payments under life insurance or endowment contracts does not constitute interest for such purposes. Amended section 861(a)(1)(A) does not apply to interest paid by an insurance company to its creditors on notes, bonds or similar evidences of indebtedness.

The provisions of amended section 861(a)(1)(A) and of new section 861(c) cease to apply in the case of amounts paid or credited after December 31, 1971.

Interest on deposits with foreign banking branches of domestic corporations

Paragraph (2) of section 2(a) of the bill amends section 861(a)(1) of the code by adding a new subparagraph (D) providing that, for taxable years beginning after December 31, 1966, interest on deposits with a foreign branch of a domestic corporation is not income from sources within the United States if the foreign branch with which the deposit is made is engaged in the commercial banking business. This rule will apply to such interest notwithstanding the fact that the recipient is a citizen or resident of the United States or domestic corporation or that the interest is effectively connected with the conduct of a trade or business within the United States by a non-resident alien or a foreign corporation. It is not necessary for this purpose that the paying corporation be carrying on a banking business within the United States. Since under the provisions of section 862(a)(1) such interest is treated as income from sources without the United States, the interest will be considered to be from sources within the foreign country in which the foreign branch is located.

Interest on bank deposits of foreign central banks of issue or the Bank for International Settlements

Paragraph (3) of section 2(a) of the bill amends section 895 of the code (relating to income derived by a foreign central bank of issue

from obligations of the United States) and makes conforming amendments. Under present section 895 income derived by a foreign central bank of issue from obligations of the United States owned by such bank is excluded from gross income, if such obligations are not held for, or used in connection with, the conduct of commercial banking functions or other commercial activities of such bank. Amended section 895 continues existing law and provides a similar exclusion with respect to interest derived by a foreign central bank of issue from deposits with persons carrying on the banking business; it also contains a new provision under which the Bank for International Settlements will be entitled to exclude from gross income interest derived on deposits with persons carrying on the banking business if such deposits are not held for, or used in connection with, the conduct of commercial banking functions or other commercial activities by such depositor. These amendments are effective for taxable years beginning after December 31, 1966. It is to be noted, however, that the exclusion under section 895 for interest on deposits with persons carrying on the banking business will continue to apply in the case of amounts paid or credited after December 31, 1971, even though the provisions of amended section 861(a)(1)(A) cease to apply to amounts paid or credited after that date.

(b) *Dividends*.—Subsection (b) of section 2 of the bill amends section 861(a)(2) of the code (relating to dividends from sources within the United States).

Dividends from foreign corporations

Paragraph (1) of section 2(b) of the bill amends subparagraph (B) of section 861(a)(2) of the code (relating to the source of dividends from a foreign corporation). Under present section 861(a)(2)(B), if a foreign corporation derives 50 percent or more of its gross income from sources within the United States for the applicable period preceding the declaration of dividends, an amount which bears the same ratio to such dividends as the gross income of the corporation for such period from sources within the United States bears to its gross income from all sources for such period is considered to be a dividend from sources within the United States.

Under amended section 861(a)(2)(B) dividends paid by a foreign corporation are from sources within the United States only if 80 percent or more of the total gross income of such corporation from all sources for the applicable period preceding the declaration of the dividends was effectively connected with the conduct of a trade or business within the United States by such foreign corporation. The amount of the dividends treated as income from sources within the United States in such case is the amount which bears the same ratio to the dividends which are paid as the gross income of the foreign corporation for such period which is effectively connected with the conduct of a trade or business in the United States bears to the gross income of such corporation from all sources for such period. This amendment is effective with respect to dividends received after December 31, 1966; but, to the extent that gross income of the foreign corporation for any period before its first taxable year beginning after December 31, 1966, must be taken into account in determining the application of amended section 861(a)(2)(B), the gross income of such

corporation for such period from sources within the United States will be considered, by reason of the amendment contained in paragraph (2) of section 2(b) of the bill, to be gross income effectively connected with the conduct of a trade or business within the United States.

The substance of the provision in section 861(a)(2)(B) of the code which provides in effect that, for purposes of determining the foreign tax credit, dividends paid by a foreign corporation are from sources without the United States to the extent that they exceed an amount which is 100/85ths of the amount of the deduction allowable under section 245 of the code in respect of such dividends is not changed by the bill. Thus, for example, if a dividend paid by a foreign corporation is not considered to be from sources within the United States under amended section 861(a)(2)(B) because less than 80 percent of such corporation's gross income from all sources for the applicable period was effectively connected with its conduct of a trade or business in the United States, and if the recipient of such dividend is a corporation which is allowed a deduction in respect of such dividend under section 245, as amended by section 4(d) of the bill, because 50 percent or more of the foreign corporation's gross income from all sources for the applicable period was effectively connected with the conduct of a trade or business within the United States by the foreign corporation, only a portion of such dividend is treated as income from sources without the United States for purposes of the foreign tax credit.

(c) *Personal services.*—Subsection (c) of section 2 of the bill amends subparagraph (C)(ii) of section 861(a)(3) of the code (relating to the source of income from personal services). The amendment is effective for taxable years beginning after December 31, 1966. Existing section 861(a)(3) provides that compensation for personal services performed in the United States is income from sources within the United States except in a case where the tests contained in subparagraphs (A), (B), and (C) are satisfied in respect of the compensation. Subparagraph (C)(ii) presently provides, as one of the tests to be satisfied, that the exception to the general source rule of section 861(a)(3) applies only if the compensation is for services performed by the nonresident alien individual as an employee of, or under a contract with, a domestic corporation, if the 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 domestic corporation. The test prescribed by amended subparagraph (C)(ii) continues the existing provision but broadens it so as to apply to services performed by the nonresident alien individual 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.

(d) *Definitions.*—Subsection (d)(1) of section 2 of the bill amends section 864 of the code (relating to definitions) by redesignating the existing provisions of section 864 as section 864(a). Subsection (d)(2) of section 2 of the bill adds new subsection (b) (relating to trade or business within the United States) and new subsection (c) (relating to effectively connected income) to section 864. These amendments are effective for taxable years beginning after December 31, 1966.

Trade or business within the United States

New section 864(b) specifies rules for determining whether certain activities do, or do not, constitute engaging in trade or business within the United States for purposes of part I (relating to determination of sources of income) of subchapter N of the code, of part II (relating to nonresident aliens and foreign corporations) of subchapter N, and of chapter 3 (relating to withholding of tax on nonresident aliens and foreign corporations and tax free covenant bonds) of the code. A similar provision in existing section 871(c) of the code is deleted from section 871, as amended by section 3(a) of the bill, and replaced by the provisions of new section 864(b).

Paragraph (1) of new section 864(b) is substantively identical to the provisions of the second sentence of existing section 871(c) (relating to U.S. business), except that the test of existing section 871(c) (2) has been broadened to conform to section 861(a) (3) (C) (ii), as amended by subsection (c) of this section of the bill. This conforming amendment permits the nonresident alien individual, subject to the other conditions, to perform services in the United States 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 (as well as by a domestic corporation) yet not be considered to be engaged in trade or business within the United States.

Paragraph (2) of new section 864(b) concerns trading in stocks, securities, or commodities. Existing section 871(c) of the code provides that a nonresident alien individual or foreign corporation is not engaged in trade or business within the United States if he effects, through a resident broker, commission agent, or custodian, transactions in the United States in stocks or securities. This provision has been so interpreted, however, that the nonresident alien individual is engaged in trade or business within the United States if the trading in securities would otherwise constitute engaging in trade or business and if the trading transactions are effected while the nonresident alien individual is present in the United States (*Zareh Nubar*, 13 T.C. 566 (1949), rev'd 185 F. 2d 584 (4th Cir. 1950), cert. denied 341 U.S. 925 (1951)). It has also been held that a nonresident alien individual is engaged in trade or business in the United States when his trading in securities is otherwise sufficient to constitute a trade or business and such transactions are effected by a resident agent who exercises discretionary authority with respect to such trading (*Fernand Adda*, 10 T.C. 273 (1948), aff'd 171 F. 2d 457 (4th Cir. 1948), cert. denied 336 U.S. 952 (1949)).

Subparagraph (A) (i) of section 864(b) (2) provides generally that a nonresident alien individual or foreign corporation who is not a dealer in stocks or securities is not engaged in trade or business within the United States by reason of trading in stocks or securities for the taxpayer's own account, irrespective of where the activities instrumental to such trading are performed or how the actual trading transactions are effected. It is immaterial whether the corporation or individual conducts the trading activities and effects the stock or security transactions himself or through his employees or uses agents in the United States, whether independent or dependent, to perform any or all of the functions instrumental to such trading. It is also immaterial

whether any such employee or agent, wherever located, is authorized to exercise his own discretion in trading activities conducted, or in effecting transactions, on behalf of his employer or principal. Moreover, the volume of stock or security transactions effected during the taxable year is not material in determining under section 864(b) (2) (A) (i) whether the individual or corporation is engaged in trade or business within the United States.

The provisions of subparagraph (A) (i) of section 864(b) (2) do not apply to a corporation the principal business of which is trading in stocks or securities for its own account and which maintains its principal office in the United States, unless such corporation is a personal holding company or would be a personal holding company but for section 542(c) (7) of the code, as amended by section 4(f) of the bill. Thus, for example, where a foreign investment company (which is not a personal holding company, other than by reason of section 542(c) (7)) has its principal office in the United States it is to be considered to be engaged in trade or business within the United States by reason of its trading in the United States in stocks or securities, and its income from its trading activities, as well as the dividends and interest received on the stocks and securities it holds as a result of such trading activities, constitute income effectively connected with its conduct of a trade or business within the United States. On the other hand, if the foreign investment company does not have its principal office in the United States, it is entitled to all the benefits provided by new section 864(b) (2) (A) (i) in respect of its trading in stocks or securities for its own account as are accorded under such section to a nonresident alien individual who is not a dealer in stocks or securities. For purposes of making the determination in respect of the foreign corporation's "principal office," a foreign corporation will be considered to have only one principal office; and an office will not be considered to be the principal office of a foreign corporation solely because it is a statutory office of such corporation.

Subparagraph (A) (ii) of section 864(b) (2) permits nonresident alien individuals and foreign corporations who are dealers in stocks or securities to trade in stocks or securities through a resident broker, commission agent, custodian, or other independent agent without being considered to be engaged in trade or business within the United States by reason of such activities. However, this provision is limited by subparagraph (C) of section 864(b) (2), as added by this section of the bill, and applies only if the dealer does not maintain an office or place of business in the United States at any time during the taxable year through which, or by the direction of which, the transactions in stocks or securities are effected.

Subparagraph (B) of section 864(b) (2) provides generally that a nonresident alien individual or a foreign corporation may engage in certain trading activities in commodities for the taxpayer's own account without being engaged in trade or business within the United States. The rules set out in subparagraph (B) are basically identical to those contained in subparagraph (A) of new section 864(b) (2) concerning trading in stocks or securities, except that (1) the provision applicable to traders who are not dealers in commodities applies whether or not such persons are corporations the principal business

of which is trading in commodities and the principal office of which is in the United States; and (2) in the case of both dealers and nondealers, the provisions of subparagraph (B) apply only if the commodities traded 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. This last exception, which is contained in subparagraph (B)(iii) of section 864(b)(2) corresponds to provisions contained in existing section 871(c) of the code.

Subparagraph (C) of section 846(b)(2) limits the application of subparagraphs (A) and (B) of that section, as those subparagraphs apply to dealers in stocks or securities or commodities, to those cases in which such dealers have no office or place of business within the United States at any time during the taxable year which is responsible, directly or indirectly, for effecting the trading activities. A similar provision is contained in existing section 871(c), but the existing provision does not apply to transactions in stocks or securities and it is not limited in its application to dealers only. For purposes of paragraph (2) of amended section 864(b), a person who is a dealer in securities or commodities shall be considered a dealer in securities or commodities, even though such person's transactions in securities or commodities conducted in the United States would not constitute such person as a dealer.

Effectively connected income, etc.

New section 864(c) contains rules to be used in determining whether income, gain, or loss is effectively connected with the conduct of a trade or business within the United States by a nonresident alien individual or foreign corporation. Income, gain, or loss which is effectively connected with the conduct of a trade or business within the United States is taken into account in determining the tax imposed in accordance with sections 871(b) and 882(a), as amended by sections 3(a) and 4(b) of the bill, respectively. Income, gain, or loss from sources within the United States which is not effectively connected with the conduct of a trade or business within the United States may be taken into account in determining the tax imposed by sections 871(a) and 881, as amended by sections 3(a) and 4(a) of the bill, respectively. Existing law does not require a determination as to whether income is, or is not, effectively connected with the conduct of a trade or business within the United States by a nonresident alien individual or by a foreign corporation.

General rule

Paragraph (1) of new subsection (c) provides that the rules contained in paragraphs (2), (3), and (4) of such subsection for determining whether income, gain, or loss shall be treated as effectively connected with the conduct of a trade or business within the United States shall apply only in the case of a nonresident alien individual, or of a foreign corporation, which is engaged in trade or business within the United States at some time during the taxable year for which the tax is being determined. Such paragraph also provides that no income, gain, or loss derived by a nonresident alien individual, or a foreign corporation, not engaged in trade or business within the United States during the taxable year will be treated as effectively

connected with the conduct of a trade or business within the United States, except in the case of income from real property derived from sources within the United States during a taxable year for which the election provided by amended section 871(d) or 882(d) is in effect.

Periodical, etc., income from sources within United States—Factors

Paragraph (2) of new subsection (c) contains rules for determining whether certain income, gain, or loss from sources within the United States is effectively connected with the conduct of a trade or business within the United States. Under these rules in making the determination as to whether income or gains from sources within the United States which are of the type described in amended section 871(a) (1) or 881(a), or gain or loss from sources within the United States derived from the sale or exchange of property which is a capital asset (as defined in sec. 1221 of the code), will be considered effectively connected with the conduct of a trade or business within the United States, factors such as those specified in subparagraphs (A) and (B) of such paragraph (2) are to be taken into account.

The factors specified in subparagraphs (A) and (B) of paragraph (2) are whether first, the income, gain, or loss is derived from assets used in, or held for use in, the conduct of the trade or business within the United States; and second, the activities of such trade or business within the United States were a material factor in the realization of the income, gain, or loss. In applying these factors, due regard is to be given to whether or not such asset or such income, gain, or loss was accounted for through such trade or business. Thus, in determining the income which is effectively connected with the conduct of a trade or business in the United States, consideration will be given to the fact that the asset giving rise to the income, gain, or loss described in paragraph (2), or such income, gain, or loss itself, is carried on books of account separately kept for the trade or business conducted in the United States.

In determining whether income, gain, or loss of the types described in paragraph (2), of new subsection (c), is effectively connected with the conduct of a trade or business within the United States, particular attention will be given to the first factor; i.e., whether the asset giving rise to such income, gain, or loss is used in, or held for use in, such trade or business. This factor is especially important in the case of income of a passive type where business activities are not likely to be a direct or material contributor to the realization of this income. However, even in this case, the contribution of activities in carrying on a trade or business to the realization of the income, gain, or loss will also be taken into account if such activities are an important factor in contributing to the realization of the income. This business activity factor will be of primary significance in the case of income described in paragraph (2), whether generally passive or not, where the operation is a financial, banking, or similar business or is a licensing business and the income arises from these activities. In the case of a corporation, activity relating to management of investments will not be treated as related to the conduct of a trade or business within the United States unless the maintenance of such investments constitutes the principal activity of such corporation.

In general, an asset held for the principal purpose of promoting the conduct of a trade or business in the United States is to be considered held for use in such trade or business, and any income, gain, or loss derived from such asset will be treated as effectively connected with the conduct of such trade or business. The income, gain, or loss derived from an asset acquired in the ordinary course of a trade or business conducted in the United States (e.g., interest on a trade account receivable) will generally be considered derived from the activities of such trade or business and treated as effectively connected with the conduct of such trade or business.

Example.—F, a foreign corporation, is engaged in manufacturing operations in the United States. In order to secure a constant source of supply for its U.S. factory, F corporation purchases stock in domestic corporation N. Dividends on, and any gain realized on the disposition of, such stock will be considered income effectively connected with the conduct of the U.S. business.

If there is no direct relationship between the U.S. business and the holding of the asset, such asset will not generally be considered used in, or held for use in, such business, and the income from such asset will not be considered effectively connected with the conduct of such business. In determining whether such a direct relationship exists, consideration is to be given primarily to the connection between the asset and the needs of the U.S. business. However, also to be taken into account in applying the factors are: (1) the source of the funds or other assets which were used to acquire the asset in question; (2) the disposition of the income from such asset; and (3) the extent of management and control by the U.S. business over such asset. Generally, the presence of these three factors is to be determinative of the assets being used in the business without showing that the income or assets are needed in the U.S. business.

The significance to be attached to the disposition of the income will depend on the amount of such income and its relation to the other activities of the U.S. business. Management activities relating to an asset are to be taken into account in determining whether a particular asset is used in, or held for use in, the conduct of a trade or business within the United States only if they are significant in relation to the investments involved. Income from investment assets is not to be considered effectively connected with the conduct of a U.S. business merely because employees of that business exercise management or control over such assets.

Investment income realized by a nonresident alien individual engaged in business within the United States by reason of his performing personal services in the United States will not be treated as income effectively connected with the conduct of a trade or business within the United States, unless there is a direct economic relationship between his holding of the assets from which such income results and his business of performing the personal services. Where there is such a relationship, as for example, where such an individual purchases stock in a domestic corporation to assure the opportunity of performing personal services in the United States for such corporation, income derived from such assets may be effectively connected with his conduct of such business within the United States.

These principles in respect of income described in paragraph (2) from U.S. sources may be illustrated by the following examples:

Example (1).—M is a foreign corporation engaged in industrial manufacturing in a foreign country. Corporation M maintains a branch in the United States which acts as importer and distributor of the merchandise manufactured abroad; by reason of such branch activities, M corporation is engaged in business in the United States. The branch in the United States is required to hold a large current cash balance for business purposes, but the amount of the cash balance required varies because of the fluctuating seasonal nature of the branch's business. During periods when large cash balances are not required the branch invests the surplus amount in U.S. Treasury bills. These Treasury bills are considered assets used in, or held for use in, the U.S. business, irrespective of where the bills are physically located and irrespective to which office of M corporation the interest thereon is paid. Accordingly, such interest is income effectively connected with the conduct of the business in the United States.

Example (2).—The facts are the same as in example (1) except that M corporation also receives interest on overdue accounts receivable which it acquired on the sale of goods through the U.S. branch. Such interest is effectively connected with the conduct of the business within the United States since the activities of the U.S. branch were a material factor in the realization of such income.

Example (3).—O, a foreign corporation engaged in the manufacture of goods, maintains a factory in the United States and by reason of its activities therein is engaged in business in the United States. Corporation O owns securities of domestic corporations, such securities having been purchased with funds from O corporation's general surplus reserves, and engages a stock brokerage firm in the United States to manage such securities. The brokerage firm is engaged by the U.S. factory and is instructed to deposit all income and gains derived from such securities in the New York bank account of the factory in the United States. This account is not needed to meet such factory's operating expenses. All such income and gains are not effectively connected with the conduct of the business within the United States because the assets giving rise to such income and gains are not held for use in such business.

Example (4).—X, a foreign corporation engaged in the manufacture of goods in a foreign country, maintains a branch in the United States and by reason of the activities of such branch is engaged in business in the United States. Corporation X invests excess cash, which is generated by the branch and not needed in its business, in securities issued by domestic corporations. The securities are held in the name of X corporation in a brokerage office in the United States, which office receives and remits all income from the securities to X corporation's home office abroad. The officers of the U.S. branch have authority to manage the securities held in X corporation's brokerage account. The dividends and interest paid on the securities, and any gain or loss resulting from the sale or exchange of the securities, are not effectively connected with the conduct of the business within the United States, because such assets are not used in, or held for use in, such business.

Example (5).—Y, a foreign corporation, maintains a branch in the United States. The branch holds on its books stock of domestic corporation D, a wholly owned subsidiary of Y corporation. There is no relationship between the business of D corporation and of Y corporation's branch in the United States, and the offices of D report to the home office of Y and not to the U.S. branch. Dividends paid on the stock of D corporation are paid to Y corporation's branch in the United States and are mingled with its general funds. However, such branch has no need in its business for the cash so received. The stock of D corporation is not used, or held for use in, the business of Y corporation's branch, and dividends paid on such stock are not effectively connected with such business.

Example (6).—Z, a foreign corporation, has a branch in the United States which acts as an importer and distributor of merchandise. As a result, Z corporation is engaged in business in the United States. Corporation Z also licenses patents to U.S. persons for use in the United States. The businesses in which such patents are used have no direct relationship to the business carried on in Z corporation's branch in the United States, although the merchandise marketed by the branch is similar in type to that manufactured under the patents. The negotiations and other activities leading up to the consummation of these licenses are conducted by employees of Z corporation who are not connected with the U.S. branch of Z corporation. Royalties received by Z corporation as a result of these licenses are not effectively connected with the conduct of its business in the United States because the activities of the business conducted within the United States were not a material factor in the production of such income.

For purposes of applying the provisions of paragraphs (2) and (4) of new subsection (c) in determining whether interest described in amended section 861(a)(1)(A) is effectively connected with the conduct of a trade or business within the United States (thereby determining under sec. 861(a)(1)(A) whether such interest is from sources within or without the United States), such interest shall be assumed to be income from sources within the United States to which the rules of such paragraph (2) apply and shall not be subject to the rule provided in such paragraph (4). However, if interest described in section 861(a)(1)(A) is determined to be income from sources without the United States (because not effectively connected with the conduct of a trade or business within the United States by reason of the rules of par. (2) of new subsec. (c)), such interest will not be considered to be effectively connected with the conduct of a trade or business within the United States pursuant to the rules provided in paragraph (4) of new subsection (c).

Other income from sources within United States

Paragraph (3) of new subsection (c) provides that all income, gain, or loss derived from sources within the United States (other than any income, gain, or loss to which par. (2) applies) by a nonresident alien individual, or by a foreign corporation, engaged in trade or business within the United States during the taxable year shall be treated as effectively connected with the conduct of a trade or business within the United States. Thus, the bill does not change the taxation of income from U.S. sources derived by a nonresident

alien individual, or by a foreign corporation, engaged in trade or business within the United States, if such income does not consist of income of the types described in section 871(a)(1) or 881(a) or of gains from the sale or exchange of capital assets. On the other hand, all income from sources within the United States, other than gains from the sale or exchange of capital assets which are not effectively connected with the conduct of a trade or business within the United States, are subject to U.S. tax, either under amended section 871(a)(1) or 871(b) in the case of a nonresident alien individual who is engaged in trade or business within the United States, or under amended section 881 or 882(a) in the case of a foreign corporation which is engaged in trade or business within the United States.

Gains which are not effectively connected with the conduct of a trade or business within the United States and which are derived from sources within the United States from the sale or exchange of capital assets are subject to U.S. tax only if the provisions of amended section 871(a)(2) apply. The income, gain, or loss to which paragraph (3) applies will be treated as income effectively connected with the conduct of a trade or business within the United States, whether or not there is any connection between such income, gain, or loss and the trade or business being carried on in the United States during the taxable year in respect of which the tax is being determined.

Income from sources without the United States

Paragraph (4) of new subsection (c) contains the rules applicable for determining, in the case of a nonresident alien individual, or of a foreign corporation, engaged in trade or business within the United States during the taxable year, whether income, gain, or loss from sources without the United States is to be treated as income, gain, or loss which is effectively connected with the conduct of a trade or business within the United States.

General rule

Subparagraph (A) of paragraph (4) provides that, except as provided in subparagraphs (B) and (C), no income from sources without the United States is to be treated as effectively connected with the conduct of a trade or business within the United States. Under existing law, a nonresident alien individual or a foreign corporation is not subject to U.S. tax upon any of its income derived from sources outside the United States, except in the case of a life insurance company to which section 819(a) of the code applies. The provisions of sections 861 through 863 of the code are to apply in determining whether an item of income is from sources within or without the United States. Section 864(c) does not affect these rules of source in sections 861 through 863 (except in the case of interest described in amended sec. 861(c) and of dividends described in amended sec. 861(a)(2)(B)).

Income attributable to business office in the United States

Subparagraph (B) of paragraph (4) describes certain types of income, gain, or loss which, although treated as income, gain, or loss from sources without the United States, may be treated as income, gain, or loss effectively connected with the conduct of a trade or business within the United States and therefore be taken into account for purposes of

determining the tax imposed pursuant to amended section 871(b) or 882(a) of the code. To be so treated, the requirements of subparagraph (B), including the specific requirements of either clause (i), (ii), or (iii) thereof, must be satisfied.

Income, gain, or loss described in clause (i), (ii), or (iii) of subparagraph (B) is to be treated as effectively connected with the conduct of a trade or business within the United States only if the nonresident alien individual or the foreign corporation is engaged in trade or business within the United States during the taxable year and maintains a business office or other fixed place of business within the United States during such year. In addition, the items of income, gain, or loss described in clause (i), (ii), or (iii) must be attributable to such business office or other fixed place of business.

A nonresident alien individual or foreign corporation is not to be considered to have a business office or other fixed place of business in the United States merely because such alien individual or foreign corporation uses another person's office or other fixed place of business in the United States through which to transact business, if the alien individual's or foreign corporation's business activities in such office or other fixed place of business are relatively sporadic or infrequent, taking into account the overall needs and conduct of the business of such alien individual or foreign corporation. A foreign corporation will not be considered to have a business office or other fixed place of business in the United States merely because a person controlling such corporation has a business office or other fixed place of business in the United States from which he exercises general supervision and control over the policies of such foreign corporation.

Example (1).—A, a foreign corporation, is engaged in the business of buying and selling tangible personal property. Corporation A is a wholly owned subsidiary of B, a domestic corporation engaged in the business of buying and selling similar property, which has an office in the United States. Officers of B corporation are generally responsible for the policies followed by A corporation and are directors of A corporation, but A corporation has an independent group of officers, none of whom are regularly employed in the United States. In addition to this group of A corporation officers, that corporation has a managing director, C, who is also an officer of B corporation but who is permanently stationed outside the U.S. The day-to-day conduct of A corporation's business is handled by C and its other officers, but they regularly confer with the officers of B corporation and on occasion visit B corporation's office in the United States, at which times they continue to conduct the business of A corporation. Absent other circumstances, A corporation does not have a business office or other fixed place of business in the United States, even though it may be engaged in trade or business within the United States.

Example (2).—The facts are the same as in example (1) except that, on rare occasions, an employee of B corporation receives an order which he, after consultation with officials of A corporation and because B corporation cannot fill the order, accepts on behalf of A corporation rather than on behalf of B corporation. B corporation does not hold itself out as a person which those wishing to do business with A corporation should contact. Assuming that orders

are seldom handled in this manner and that they do not constitute a significant part of A corporation's business, A corporation will not be considered to have a business office or other fixed place of business in the United States because of these activities of an employee of B corporation.

Example (3).—The facts are the same as in example (1) except that all orders received by A corporation are subject to review by an officer of B corporation before acceptance. Corporation A has a business office in the United States. For the determination of the income attributable to such office, see the discussion below.

Income, gain, or loss described in clause (i), (ii), or (iii) of subparagraph (B) is not to be considered effectively connected with the conduct of a trade or business in the United States unless such income, gain, or loss is attributable to a business office or other fixed place of business located in the United States. For this purpose, if only a part of the income, gain, or loss from a transaction, or series of transactions, is properly considered attributable to such office or other fixed place of business within the United States, only that part shall be treated as effectively connected with the conduct of a trade or business within the United States. In general, if a nonresident alien individual or foreign corporation has only one business office or other fixed place of business, and such office or other fixed place of business is located within the United States, all of such taxpayer's income described in clause (i), (ii), or (iii) of subparagraph (B) will be considered attributable to such office or other fixed place of business. The items of income, gain, or loss to which subparagraph (B) applies are described in clauses (i), (ii), and (iii), thereof, respectively.

Rents or royalties

Clause (i) of subparagraph (B) applies to rents or royalties for the use of, or for the privilege of using, intangible personal property located without the United States or from any interest in such property, including rents or royalties for the use, or for the privilege of using, outside the United States, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like properties, and any gain or loss realized on the sale of any such property. It does not apply to rents or royalties paid for the use of, or for the privilege of using, real property or tangible personal property.

In general, an item of income constituting rents or royalties to which clause (i) of subparagraph (B) applies will not be attributed to a business office or other fixed place of business in the United States unless the lease or license giving rise to such income is made by or through such office or other fixed place of business. For this purpose, a lease or license is to be treated as made by or through a business office or other fixed place of business in the United States if such office or other fixed place of business either actively participates in soliciting, negotiating, or performing other activities required to arrange, the lease or license from which such rents or royalties are derived or performs significant services incident to such lease or license. However, no income to which clause (i) applies will be attributed to a business office or other fixed place of business in the United States merely because such office or other fixed place of busi-

ness (1) developed or otherwise acquired the property which is leased or licensed or (2) exercised general supervision over the activities of the persons directly responsible for carrying on the activities (of soliciting, negotiating, servicing, etc.) described in the preceding sentence.

Example.—F, a foreign corporation, is engaged in the active conduct of a business of licensing patents which it has either purchased or developed in the United States. Corporation F has an office in the United States. Licenses for the use of such patents outside the United States are negotiated by other than the U.S. office of F corporation, subject to approval by an officer of such corporation at his office in New York. All services which are rendered to F corporation's foreign licensees are performed by employees of F corporation's offices outside the United States. None of the income, gain, or loss resulting from the foreign licenses so negotiated by F corporation is attributable to its office in the United States and therefore is not effectively connected with its conduct of the business in the United States.

Dividends, interest, or gains derived in financing business

Clause (ii) of subparagraph (B) applies to dividends or interest, or to gain or loss from the sale or exchange of stock or notes, bonds, or other evidences of indebtedness, if such items of income or loss are either derived in the active conduct of a banking, financing, or similar business within the United States by the nonresident alien individual or foreign corporation or received by a foreign corporation the principal business of which is trading in stocks or securities for its own account.

Absent unusual circumstances, any income, gain, or loss described in clause (ii) which is derived in the active conduct of a banking, financing, or similar business within the United States either will be attributed in whole to the business office or other fixed place of business maintained within the United States by the nonresident alien individual or foreign corporation or will not be attributed in any degree to such office or other fixed place of business. Under section 864(b)(2)(A), as added by section 2(d) of the bill, a foreign corporation, the principal business of which is trading in stocks or securities for its own account, is to be treated as engaged in trade or business in the United States by reason of its stock or securities transactions in the United States if it (1) maintains its principal office in the United States and (2) is not a personal holding company (or a company which would be a personal holding company except for amended sec. 542(c)(7) of the code). If such a foreign corporation trades in the United States in stocks or securities and by reason of section 864(b)(2)(A) is treated as not being engaged in trade or business within the United States, no income described in clause (ii) of subparagraph (B) which is from sources without the United States will be treated as attributable to any office or other fixed place of business such corporation may have in the United States, even though such office or other fixed place of business participates in, or is used in, the conduct of such trading activities.

In general, income described in clause (ii) of subparagraph (B) does not include income from stocks or securities which are purchased for investment purposes only, and a corporation will not be treated as having as its principal business trading in stocks or securities, merely

because of incidental investments held by it. Thus, a foreign corporation whose principal activity is holding stocks or securities of corporations in which it owns a significant percentage of the outstanding voting stock will generally not be considered to have as its principal business trading in stocks or securities.

Example.—M, a foreign corporation, owns voting stock in corporations A, B, and C, its holdings in such corporations constituting 15, 20, and 100 percent, respectively, of their outstanding voting stock. Each of such stock holdings by M corporation represents approximately 20 percent of M corporation's total assets. The remaining 40 percent of M corporation's assets consist of other investments, 20 percent being invested in foreign government securities and stocks and bonds of other corporations in which M corporation does not own a significant percentage of the voting stock, and 20 percent being invested in bonds issued by B corporation. None of the assets of M corporation are held for sale, but, if the officers of such corporation were to believe another investment would be preferable to its holdings of such securities of foreign governments and such other corporations, M corporation would sell such securities and reinvest the proceeds therefrom. For purposes of section 864(c) (4) (B) (ii), M corporation is not engaged in the active conduct of a banking, financing, or similar business and does not have for its principal business trading in stocks or securities for its own account.

Sales of inventory through United States office

Clause (iii) of subparagraph (B) applies to income derived from the sale outside the United States of personal property described in section 1221(1) of the code (inventory items and property held primarily for sale to customers in the ordinary course of business) if the sale was made through the business office or other fixed place of business maintained in the United States by the nonresident alien individual or foreign corporation. For this purpose, a sale is to be considered as made through a business office or other fixed place of business in the United States only if such office or other fixed place of business actively participates in soliciting, negotiating, or performing other activities required to arrange for such sale. Sales made as a result of an order solicited by, or received in, a business office or other fixed place of business in the United States are to be considered as made through such office or other fixed place of business except where an order is received unsolicited in the office or other fixed place of business and such office or other fixed place of business is not held out to potential customers as the place to which orders directed to the nonresident alien individual or foreign corporation should be sent. In determining whether a sale of personal property is made through a business office or fixed place of business within the United States, section 2(e) of the bill (relating to effective dates) provides that activities conducted in the United States on or before February 24, 1966, in negotiating or carrying out a binding contract entered into on or before such date are not to be taken into account.

If a sale is made through a business office or other fixed place of business in the United States, the amount of income realized on the sale which will be treated as attributable to such office or other fixed place of business in the United States shall not exceed the amount

which would be treated as gross income from sources within the United States under sections 861 through 863 of the code if the property had been sold in the United States. Thus, for example, if a foreign corporation's branch in the United States sells outside the United States for use in the United States, goods which the home office of the corporation manufactures in a foreign country, the profit attributable to the branch in the United States may not exceed the income which under section 863 would be from sources within the United States if the goods had been sold in the United States.

In no case, however, will any income from a sale outside the United States of purchased personal property described in section 1221(1) of the code, where such sale is made through a business office or other fixed place of business in the United States by a nonresident alien individual or a foreign corporation, be treated as effectively connected with the conduct of a trade or business within the United States if the property is sold for use, consumption, or disposition outside the United States and an office or other fixed place of business maintained by the nonresident alien individual or foreign corporation outside the United States participated materially in such sale. For this purpose, an office or other fixed place of business maintained outside the United States will be considered to have participated materially in a sale if such foreign office or other fixed place of business (1) solicited the order which is the basis for the sale, (2) negotiated the contract of sale, or (3) performed significant services incident to such sale which were necessary to its consummation and were not subject to a separate agreement between the seller and the buyer. A foreign office or other fixed place of business will not be considered to have participated materially in a sale merely because (1) the sale is made subject to the final approval of such office or other fixed place of business, (2) the property sold was held in, and distributed from, such office or other fixed place of business, (3) such office or other fixed place of business was used for purposes of having title to the property pass outside the United States, or (4) such office or other fixed place of business performed merely clerical functions incident to such sale.

Generally, all the income derived from the sale outside the United States of personal property for use, consumption, or disposition outside the United States which would be United States source income if the property had been sold within the United States will be treated, for purposes of section 864(c)(4)(B), as attributable to a business office or other fixed place of business within the United States if the sale is made through such office or other fixed place of business and no office or other fixed place of business maintained by the taxpayer outside the United States participated materially in such sale.

Income from United States life insurance business

Subparagraph (C) of paragraph (4) provides that, in the case of a foreign corporation which is carrying on a life insurance business in the United States and is taxable, as provided by section 842 of the code, as amended by section 4(g)(1) of the bill, on its income which is effectively connected with the conduct of a life insurance business within the United States, all income of such corporation from sources without the United States which is attributable to its U.S. business

shall be treated as effectively connected with the conduct of a trade or business within the United States. This provision is consistent with the treatment accorded by existing section 819(a) of the code in the case of a foreign life insurance company carrying on a life insurance business within the United States.

Excluded dividends, interest, royalties, and subpart F income

Subparagraph (D) of paragraph (4) provides, notwithstanding the provisions of subparagraphs (B) and (C), that certain types of income, gain, or loss from sources without the United States are in no case to be treated as effectively connected with the conduct of a trade or business within the United States by a nonresident alien individual or foreign corporation. Clause (i) of subparagraph (D) provides for the exclusion of dividends, interest, or royalties from sources without the United States paid by a foreign corporation in which the taxpayer owns (within the meaning of sec. 958(a) of the code), or is considered as owning (by applying the constructive ownership rules of sec. 958(b)), more than 50 percent of the total combined voting power of all classes of stock entitled to vote.

Clause (ii) of subparagraph (D) provides for the exclusion of any income from sources without the United States which is subpart F income within the meaning of section 952(a) of the code. Under that section a foreign corporation can have subpart F income only if it is a controlled foreign corporation within the meaning of section 957. In general, the subpart F income of a controlled foreign corporation is includible in the income of its shareholders who are U.S. shareholders within the meaning of section 951(b). However, exceptions to this general rule are provided by sections 951 (c) and (d) and 963 of the code. For purposes of the exclusion provided by clause (ii) of subparagraph (D), income of a controlled foreign corporation may be subpart F income even though some of such income is not includible in the income of a U.S. shareholder under section 951 because of the ownership of shares in such company by foreign shareholders. However, income of a controlled foreign corporation will not be considered subpart F income for purposes of clause (ii) of subparagraph (D) if it is excluded from subpart F income by any provision of subpart F of part III of subchapter N of chapter 1 of the code.

(e) *Effective dates.*—Subsection (e) of section 2 of the bill provides the effective dates for the amendments made by section 2 of the bill. Paragraph (1) provides that the amendments made by subsections (a), (c), and (d) apply with respect to taxable years beginning after December 31, 1966, except that in applying section 864(c)(4)(B)(iii) of the code, as added by subsection (d) of section 2, with respect to a binding contract entered into on or before February 24, 1966, activities in the United States on or before such date in negotiating or carrying out such contract are not to be taken into account. Paragraph (2) provides that the amendments made by subsection (b) apply with respect to amounts received after December 31, 1966. Section 861(c) of the code, as added by subsection (a)(1)(B) of section 2, also provides that amended section 861(a)(1)(A) and new section 861(c) are to cease to apply with respect to amounts paid or credited after December 31, 1971.

SECTION 3 OF BILL. NONRESIDENT ALIEN INDIVIDUALS

(a) *Tax on nonresident alien individuals.*—Subsection (a) of section 3 of the bill amends section 871 of the code (relating to the taxation of nonresident alien individuals). The amendment is effective for taxable years beginning after December 31, 1966.

Under existing section 871 nonresident alien individuals who are not engaged in trade or business in the United States at any time during the taxable year are subject under subsection (a)(1) to a flat tax of 30 percent on all fixed or determinable annual or periodical income from sources within the United States as well as on certain amounts treated as gains from the sale or exchange of a capital asset. Capital gains from sources within the United States are taxed at a flat rate of 30 percent under subsection (a)(2): If such individual is present in the United States for less than 90 days during the taxable year, only the gains realized during his presence in the United States are taxed; if he is present in the United States 90 days or more during the taxable year, all the gains realized during the taxable year are taxed. If the nonresident alien individual who is not engaged in trade or business within the United States at any time during the taxable year derives more than \$21,200 in income described in section 871(a) from sources within the United States, section 871(b) of existing law provides that he is subject to tax on that income at the graduated rates provided in section 1 or 1201(b) if the tax so computed is 30 percent or more of such income.

Section 871(c) of existing law provides that nonresident alien individuals engaged in trade or business within the United States at any time during the taxable year are taxable on all income from U.S. sources at the graduated rates prescribed by section 1 or 1201(b); such section also prescribes rules for determining whether a nonresident alien individual or a foreign corporation is, or is not, engaged in trade or business within the United States. Existing section 871(d) contains special rules for treating participants in certain exchange or training programs as though they were engaged in trade or business within the United States, and section 871(e) contains cross references.

A number of substantive changes in the manner of taxing nonresident alien individuals are accomplished by the amendment of existing section 871. Under amended section 871 a flat tax of 30 percent is imposed on certain income from sources within the United States which is not effectively connected with the conduct of a trade or business within the United States, including capital gains realized during the taxable year if the nonresident alien individual is present in the United States 183 days or more during the taxable year; the graduated tax under section 1 or 1201(b) is imposed upon all income, regardless of its source, which is effectively connected with the conduct of a trade or business within the United States; and an election is provided to treat certain real property income as income which is effectively connected with the conduct of a trade or business within the United States. The graduated tax imposed by existing section 871(b) is eliminated, and the definition of engaged in trade or business within the United States is revised and transferred to new section 864(b) by section 2(d)(1) of the bill.

CODE SECTION 871. TAX ON NONRESIDENT ALIEN INDIVIDUALS

(a) *Income not connected with U.S. business—30-percent tax.*—Subsection (a) of amended section 871 imposes a tax on certain gross income received by a nonresident alien individual from sources within the United States which is not effectively connected with the conduct of a trade or business within the United States. The tax applies whether or not the individual is engaged in trade or business within the United States during the taxable year.

Income other than capital gains

Paragraph (1) of amended section 871(a) provides that three categories of income are taxable at a flat rate of 30 percent if such income is from sources within the United States and is not effectively connected with the conduct of a trade or business within the United States by the individual receiving such income. The types of income subject to tax at the 30-percent rate are:

(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 402(a)(2), 403(a)(2), or 631(b) or (c), and gains on transfers described in section 1235, of the code; and

(3) Amounts which under section 341 of the code, or amounts which under section 1232 of the code (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.

The tax of 30 percent is imposed on the aggregate amount of the specified items of such gains, profits, or income, but only to the extent such items constitute gross income from sources within the United States. It is intended that, in the case of gains derived from the disposition of timber, coal, or iron ore, which under section 631(b) or (c) are treated as gains on the sale of such property, the full amount of the gain is subject to the tax of 30 percent without taking into account the application of section 1231 of the code for purposes of determining whether such gains are considered as gains from sales or exchanges of capital assets. Thus, the 30-percent tax applies to the section 631(b) or (c) gains, whether or not they are considered to be gains from the sale or exchange of capital assets.

This is a change from existing law, which provides that the section 631(b) or (c) amounts are taxable only if they are considered to be gains from the sale or exchange of capital assets, and from the regulations under section 871, which provide that the 30-percent tax applies to the gain which is considered in accordance with section 1231 to be gain from the sale or exchange of a capital asset. However, if the nonresident alien individual is otherwise required, in determining his tax for the taxable year, to apply the provisions of section 1231, the gains described in section 631(b) or (c) which are taken into account in determining the tax under amended section 871(a)(1) will not again be taken into account for purposes of applying section 1231. Since the gains described in sections 402(a)(2) and 403(a)(2), and the gains

on transfers described in section 1235, are always considered to be gains from the sale or exchange of a capital asset, it is not necessary to make the distinction which is made in the case of gains described in section 631 (b) or (c).

The 30-percent tax imposed by paragraph (1) of section 871(a) applies to all nonresident alien individuals who are not engaged in trade or business within the United States at any time during the taxable year. In addition, it applies to all nonresident alien individuals who are engaged in trade or business within the United States at any time during the taxable year, but only with respect to the items of income described in that paragraph which are not effectively connected with the conduct of a trade or business within the United States, whether or not the same trade or business engaged in during the taxable year. Items of income taxable under paragraph (1) are not to be taken into account in determining the tax under section 871(b) on income which is effectively connected with the conduct of a trade or business within the United States. The determination of what income is effectively connected with the conduct of a trade or business within the United States is to be made in accordance with the provisions of section 864(c), as added by section 2(d) (2) of the bill.

Capital gains of aliens present in the United States 183 days or more

Paragraph (2) of section 871 (a) provides the rules for taxation of capital gains derived from sources within the United States by nonresident alien individuals, whether or not they are engaged in trade or business within the United States. It does not apply to gains which are considered to be capital gains and are taxed under section 871 (a) (1) (B) or to capital gains which are taxed under section 871(b) as being effectively connected with the conduct of a trade or business within the United States. Capital gains from U.S. sources to which section 871(a) (2) applies are taxable under such section only if the nonresident alien individual is present within the United States for a period or periods aggregating 183 days or more during the taxable year during which such gain is realized. In such a case a flat rate tax of 30 percent is imposed on the amount by which the capital gains derived by such individual from sources within the United States and arising from sales or exchanges occurring during the year exceed the capital losses which are allocable to sources within the United States and result from sales or exchanges occurring during the year.

In determining those gains which are subject to the 30-percent tax imposed by paragraph (2) there shall be taken into account all gains and losses treated under subtitle A of the code as gain or loss from the sale or exchange of property which is a capital asset, except those gains which are considered to be capital gains and are specified in section 871(a) (1) (B) and those capital gains and losses which are effectively connected with the conduct of a trade or business within the United States. The amount of gains subject to the tax of 30 percent imposed by paragraph (2) may not be reduced by the application of the deduction for capital gains provided in section 1202 of the code, or by the application of the capital loss carryover provided in section 1212 of the code.

For purposes of applying the 183-day rule contained in paragraph (2), a nonresident alien individual who is not engaged in trade or

business within the United States at any time during the taxable year and who has not previously established a taxable year, as defined in section 441(b) of the code, is considered to have a taxable year which is a calendar year, as defined in section 441(d). Subsequent adoption of a fiscal year as the taxable year will be treated as a change in the taxpayer's annual accounting period to which section 442 applies and may only be made with the approval of the Secretary or his delegate.

If in the course of the taxable year an individual changes his status from that of a citizen or resident of the United States to that of a nonresident alien individual, or vice versa, the determination for purposes of paragraph (2) whether the individual has been present in the United States for 183 days or more during the taxable year shall be made by taking into account the entire taxable year, and not just that portion of the taxable year during which he has the status of a nonresident alien individual.

Deductions

The 30-percent tax of section 871(a) is imposed upon the gross amount of gains, profits, and income subject to tax, and no deductions are allowed except to the extent of taking losses into account for purposes of determining the excess amount of capital gains taxable under section 871(a)(2). The tax is not imposed, however, upon that portion of any item which does not constitute gross income, and thus, for example, the tax imposed under section 871(a)(1) on an annuity would be determined after the application of section 72 of the code. For rules pertaining to deductions, see section 873, as amended by subsection (c) of this section of the bill.

(b) *Income connected with U.S. business—Graduated rate of tax.*—Section 871(b) provides for the imposition of a graduated tax on the income derived by a nonresident alien individual which is effectively connected with the conduct of a trade or business within the United States.

Imposition of tax

Paragraph (1) of section 871(b) provides for a tax, to be computed at the graduated rates provided in section 1 or 1201(b), on the taxable income of a nonresident alien individual which is effectively connected with the conduct of a trade or business within the United States by such individual, whether such income is derived from sources within, or from sources without, the United States. Except as provided in amended section 871(d), the tax provided pursuant to the provisions of paragraph (1) applies only if the nonresident alien individual is engaged in trade or business within the United States at some time during the taxable year for which the tax is being determined.

The tax imposed pursuant to paragraph (1) is imposed only on the nonresident alien individual's taxable income which is effectively connected with any trade or business carried on by such individual within the United States, even though the trade or business with which the income is effectively connected is not the same as that currently carried on within the United States by such individual. Any income of such individual which is not effectively connected with a trade or business carried on within the United States is not to be taken into

account in determining the tax imposed pursuant to paragraph (1), even though such income is not subject to the 30-percent tax imposed by section 871(a). Similarly, losses which are not effectively connected with the conduct of a trade or business within the United States are not to be taken into account in determining the tax under subparagraph (1) except as provided in section 873 (b), as amended by subsection (c) of this section of the bill.

The determination of whether the nonresident alien individual is engaged in trade or business within the United States, and the determination of what gross income is to be treated as effectively connected with the conduct of such trade or business, are to be made under the rules set out in section 864 (b) and (c), as added by section 2(d) of the bill. Since a nonresident alien individual is considered to be engaged in trade or business within the United States by reason of performing personal services therein, such as an employee, the wages, salaries, fees, compensations, emoluments, or other remuneration, including bonuses, received for such personal services are income effectively connected with the conduct of such trade or business. Pensions, retirement pay, or annuities attributable to such services constitute income which is effectively connected with the conduct of such trade or business within the United States if the recipient of such income is engaged in trade or business within the United States in the taxable year of such recipient in which such income is received.

Determination of taxable income

Paragraph (2) of section 871(b) provides that, in determining taxable income for purposes of paragraph (1), gross income includes only the individual's gross income which is effectively connected with the conduct of a trade or business within the United States by such individual. The deductions from such gross income are to be determined in accordance with section 873, as amended by subsection (c) of this section of the bill. Thus, in determining the tax rate to be applied under section 1 of the code to the taxable income which is effectively connected with the conduct of a trade or business within the United States, none of the income upon which a tax is imposed under section 871(a) is taken into account.

(c) *Participants in certain exchange or training programs.*—Subsection (c) of section 871 conforms the provisions of existing section 871(d) to the amended structure of section 871. Under this amended subsection, a nonresident alien individual who 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 (relating to visiting students, teachers, trainees, etc.) is treated as if he were engaged in trade or business within the United States. The amended provision further provides that, for purposes of section 871, the portion of any scholarship or fellowship grant received by such individual which is not excluded from gross income under section 117 (a)(1) of the code solely by reason of section 117(b)(2)(B), as well as amounts (to the extent includible in gross income) received for travel, research, clerical help, or equipment, incident to such scholarship or fellowship grant, shall, to the extent derived from sources

within the United States, be treated as income 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.—Subsection (d) of section 871 provides that a nonresident alien individual may, subject to certain limitations, elect to treat certain income from real property as income effectively connected with the conduct of a trade or business within the United States. The election is available to all nonresident alien individuals, whether or not engaged in trade or business within the United States during the taxable year for which the election is made.

In general

Paragraph (1) of section 871(d) provides that an election may be made with respect to any income from real property held for the production of income and located in the United States, or from any interest in such real property, including (1) gains from the sale or exchange of any such real property or any interest in such property; (2) rents or royalties from mines, wells, or other natural deposits; and (3) gains referred to in section 631 (b) or (c) of the code. The election may be made only with respect to such income which is not effectively connected with the conduct of a trade or business within the United States. For this purpose, income from such real property does not include either interest on a debt obligation secured by a mortgage of real property or any portion of a dividend paid by a corporation or a trust (such as a real estate investment trust described in sec. 857 of the code) which derives income from real property. Income from such real property does include, however, that portion of the income included under section 652 or 662 of the code in the income of the beneficiary of a trust which is treated as consisting of income from real property.

A nonresident alien individual who makes the election under paragraph (1) will determine the tax on his income from such real property as provided in section 871 (b) even though he is not engaged in trade or business in the United States during the taxable year. Such individual is entitled to the deductions which are allowed by section 873, as amended by subsection (c) of this section of the bill, but none of such deductions shall be allowed in determining any tax under amended section 871 (a) on income which is not effectively connected with the conduct of a trade or business within the United States. Income which is treated pursuant to an election under paragraph (1) as income effectively connected with the conduct of a trade or business within the United States is to be aggregated, for purposes of determining the tax imposed pursuant to section 871 (b), with all other income for the taxable year which is effectively connected with the conduct of a trade or business within the United States. To the extent that deductions are connected with income from such real property in respect of which an election is made under paragraph (1), such deductions shall be treated as connected with income which is effectively connected with the conduct of a trade or business within the United States.

An election under paragraph (1) applies to all gains, profits, and income derived from such real property, or from any interest in such real property, located in the United States, whether or not such gains, profits, and income would be subject to tax under amended section

871(a) (1) or (2) had no election been made. If there are no gains, profits, and income which are derived from real property located in the United States, or from any interest in such real property, during the taxable year and which are taxable under section 871(a) (1) or (2), an election under paragraph (1) may not be made. But if an election has been properly made in respect of a taxable year, the election remains in effect, unless properly revoked, for subsequent taxable years with respect to all such real property located in the United States, or from any interest therein, even though during any such subsequent taxable year there are no gains, profits, or income derived from such real property.

The election under paragraph (1) is not to apply with respect to real property, *e.g.* a personal residence, which was not held for the production of income or with respect to gains, profits, and income from any transaction which was not entered into for profit. Any real property located in the United States in respect of which an election under paragraph (1) is properly in effect is to be treated as a capital asset which, if depreciable, will be subject to the allowance for depreciation provided in section 167 of the code, but is not to be treated as property used in the trade or business for purposes of section 172(d)(4)(A)(i), 1221(2), or 1231(b) of the code. Thus, for example, if a taxpayer makes the election under paragraph (1) and while such election is in effect sells nonincome-producing real property held for investment purposes, any gain realized on such sale is to be gain realized on the sale of a capital asset and is to be gain which is effectively connected with the conduct of a trade or business within the United States for purposes of section 871(b). If such sale results in a loss, the loss is not to be treated as a capital loss to which section 871(a) (2) applies.

If property with respect to which the election applies is transferred to a domestic corporation in a transaction to which section 351 of the code applies, and if at the time of the transfer such property is section 1250 property, all or part of the gain realized on the transfer may be recognized and treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231. See the amendment to section 1250(d) of the code made by subsection (j) of this section of the bill.

Once made, the election under paragraph (1) applies to all income from real property held for the production of income, which is not otherwise effectively connected with the conduct of a trade or business within the United States, derived by the electing individual in any subsequent taxable years. The election may be revoked only with the consent of the Secretary of the Treasury or his delegate.

The provisions of paragraph (1) may be illustrated by the following example:

Example.—A, a nonresident alien individual, owns two parcels of real estate located in the United States. One parcel is improved with an office building which A has leased on a long-term, net-lease basis. The other parcel is unimproved and is held for investment purposes. During the taxable year 1967, A is at no time present in the United States or engaged in trade or business within the United States. In 1967, A elects to have the income from the improved real estate treated as income which is effectively connected with the conduct of

a trade or business within the United States. A has no other income from United States sources during the taxable year. In determining his income subject to tax under section 1 of the code, A is allowed any deductions which are allowable under amended section 873; and for such purposes deductions attributable to such real property and to the income therefrom is to be treated as connected with income which is effectively connected with the conduct of a trade or business within the United States. In 1968, A sells the unimproved parcel of real estate held for investment, the election under section 871(d) still being in effect. Any gain realized from such sale, and A's income for the year from the rental property, are subject to tax under section 1 or 1201(b). If such sale is at a loss, the loss will be treated as a capital loss which is deductible under amended sections 873(a) and 1212(b) of the code.

Election after revocation

Paragraph (2) of section 871(d) provides that if an election made pursuant to the provisions of paragraph (1) has been revoked, a new election may not be made for any taxable year before the fifth taxable year beginning after the first taxable year for which such revocation was effective. A new election may be made at any time, however, if the electing individual secures the consent of the Secretary of the Treasury or his delegate.

Form and time of election and revocation

Paragraph (3) of section 871(d) provides that the election provided by paragraph (1), and any revocation thereof, is to be made in accordance with the regulations to be issued by the Secretary of the Treasury or his delegate.

(e) *Cross references.*—Subsection (e) of section 871 contains a list of cross references to certain other sections of the code.

SECTION 3 OF BILL—CONTINUED

Conforming amendment

Paragraph (2) of section 3(a) of the bill amends section 1 of the code (relating to tax on individuals) by redesignating subsection (d) as subsection (e) and by adding a new subsection (d). The new subsection provides that the tax imposed under subsection (a) of section 1 applies to nonresident alien individuals only to the extent so provided by section 871(b) or 877. The amendment is effective for taxable years beginning after December 31, 1966.

(b) *Gross income.*—Subsection (b) of section 3 of the bill amends section 872 of the code (relating to gross income of a nonresident alien individual), effective for taxable years beginning after December 31, 1966. Under existing law, the gross income of a nonresident alien individual includes only gross income from sources within the United States. Certain items of income are expressly excluded from gross income under existing section 872(b).

General rule

Paragraph (1) of section 3(b) of the bill amends section 872(a) to provide that the gross income of a nonresident alien individual includes only that income from sources within the United States which

is not effectively connected with the conduct of a trade or business within the United States and all income (whether or not derived from sources within the United States) which is effectively connected with the conduct of a trade or business within the United States.

Exclusions

Paragraph (2) of section 3(b) of the bill amends subparagraph (B) of section 872(b) (3) (relating to the exclusion from gross income of certain compensation of participants in certain exchange or training programs). Under existing law the exclusion from gross income applies only to compensation paid a qualifying nonresident alien individual by a "foreign employer," which term is defined under subparagraph (B) to include an office or place of business maintained in a foreign country or in a possession of the United States by a domestic corporation. The amendment made by this paragraph provides that an office or place of business maintained in a foreign country or in a possession of the United States by a domestic partnership or by an individual who is a citizen or resident of the United States is also within the meaning of the term "foreign employer." This amendment is consistent with the amendment of section 861(a) (3) (C) (ii) made by section 2(c) of the bill and with the provisions of section 864 (b) (1) (B), as added by section 2(d) of the bill.

Bond interest of residents of the Ryukyu Islands or the Trust Territory of the Pacific Islands

Paragraph (3) of section 3(b) of the bill adds a new paragraph (4) to section 872(b). This new paragraph excludes from the gross income of a nonresident alien individual any income derived by such 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.*—Paragraph (1) of section 3(c) of the bill amends section 873 of the code (relating to deductions allowed nonresident alien individuals). Paragraph (2) of section 3(c) of the bill amends section 154(3) of the code (relating to cross references with respect to deductions for personal exemptions), to provide the proper cross reference to section 873(b) (3), as amended by this section of the bill. These amendments are effective for taxable years beginning after December 31, 1966.

Under existing law nonresident alien individuals engaged in trade or business within the United States at any time during the taxable year are entitled to the deductions allowable under subtitle A (relating to income taxes) of the code, but only if and to the extent that such deductions are connected with income from sources within the United States. Deductions are allowed for the following items whether or not connected with income from sources within the United States: (1) Losses incurred in transactions entered into for profit, if any income from such transaction would have been subject to tax; (2) casualty or theft losses of property located in the United States; (3) charitable contributions made to certain U.S. charitable organizations other than charitable trusts; and (4) one personal exemption (except in the case of a resident of Canada or Mexico, who is allowed the regular personal exemptions).

CODE SECTION 873. DEDUCTIONS

(a) *General rule.*—Section 873(a) of the code, as amended by section 3(c) of the bill, provides that, generally, a nonresident alien individual is allowed the deductions allowable under subtitle A of the code, but only if and to the extent that such deductions are connected with income which is effectively connected with the conduct of a trade or business within the United States. The deductions so allowed may be taken only by a nonresident alien individual who is determining his tax in accordance with amended section 871(b) by reason of having gross income which is effectively connected with the conduct of a trade or business within the United States or gross income which is treated as effectively connected with the conduct of a trade or business within the United States by virtue of an election made pursuant to section 871(d), as added by section 3(a) of the bill. No deductions are to be allowed in determining the tax imposed by amended section 871(a).

Under subsection (a) of section 873 the rules governing the proper apportionment and allocation of deductions for purposes of the application of such subsection are to be prescribed in regulations issued by the Secretary of the Treasury or his delegate.

(b) *Exceptions.*—Section 873(b) provides that, for purposes of determining the tax in accordance with amended section 871(b), a nonresident alien individual who has income which is effectively connected with the conduct of a trade or business within the United States (or income which is so treated pursuant to an election under amended sec. 871(d)) is allowed certain deductions in determining his taxable income, whether or not such deductions are connected with income which is effectively connected with the conduct of a trade or business within the United States. The deductions so allowed under amended section 873(b) are: (1) The deduction for casualty or theft losses of property located within the United States allowed under section 165(c)(3) of the code; (2) the deduction for charitable contributions and gifts allowed under section 170 of the code, including contributions or gifts to or for a trust described in section 170(c)(2); and (3) the deduction for personal exemptions allowed by section 151 of the code (in the case of a nonresident alien individual who is not a resident of Canada or Mexico, only one such exemption is allowable).

For purposes of determining the application of the limitations contained in section 170(b) of the code on the amount of the deduction for charitable contributions or gifts, only that income for the taxable year which is effectively connected with the conduct of a trade or business within the United States, plus any income from real property which pursuant to an election under amended section 871(d) is treated as income so effectively connected, is to be taken into account.

If in the case of a nonresident alien individual whose tax for the taxable year is determined in accordance with amended section 871(b) the deductions allowed by section 873 exceed the gross income which is effectively connected with the conduct of a trade or business within the United States (and any income which is treated pursuant to an election under amended sec. 871(d) as income so effectively connected), such excess, to the extent constituting a net operating loss under section 172(c) of the code, may be carried, in accordance with

section 172(b) of the code, to other taxable years for which the tax is imposed pursuant to amended section 871(b). For purposes of determining the amount by which the net operating loss is reduced under section 172(b) (2) in determining the amount of carryback or carryover, any income on which the tax for the taxable year is imposed pursuant to amended section 871(a) is not to be taken into account; but, even though such income is the only income for the taxable year, such taxable year is to count as one of the taxable years to which such loss may be carried under section 172(b) (1).

(c) *Cross references.*—Subsection (c) of section 873 contains cross references to certain other sections of the code.

SECTION 3 OF BILL—CONTINUED

(d) *Allowance of deductions and credits.*—Subsection (d) of section 3 of the bill amends section 874(a) of the code (relating to the filing of a proper return as a prerequisite to the allowance of deductions and credits) by deleting the reference therein to income received from all sources in the United States. The Secretary of the Treasury or his delegate may, therefore, require the nonresident alien individual to file, as a prerequisite to the allowance of deductions and credits, a true and accurate return of his income from sources within the United States in the case of income not effectively connected with the conduct of a trade or business within the United States, and from sources within and without the United States in the case of income effectively connected with the conduct of a trade or business within the United States. This amendment is effective for taxable years beginning after December 31, 1966.

(e) *Expatriation to avoid tax.*—Subparagraph (e) of section 3 of the bill adds a new section 877 (relating to expatriation to avoid tax) to the code and makes a conforming amendment. Paragraph (1) of section 3(e) amends subpart A of part II of subchapter N of chapter 1 of the code (relating to nonresident alien individuals) by redesignating existing section 877 as section 878, and by inserting after section 876 a new section 877. Paragraph (2) of section 3(e) amends the table of sections for subpart A of part II of subchapter N of chapter 1 of the code, to conform to the amendments made by paragraph (1) of section 3(e). These amendments are effective for taxable years beginning after December 31, 1966.

CODE SECTION 877. EXPATRIATION TO AVOID TAX

(a) *In general.*—Subsection (a) of new section 877 contains a special rule applicable to nonresident alien individuals who, at any time after March 8, 1965, and within the 5-year period immediately preceding the close of the taxable year, lost their U.S. citizenship. The provisions of this subsection apply only if one of the principal purposes of such loss of citizenship was the avoidance of U.S. income, gift, or estate taxes. Expatriate U.S. citizens to whom this subsection applies are to determine their tax as nonresident alien individuals in accordance with the provisions of section 871, as amended by section 3(a) of the bill. However, if the tax so determined is less than the tax de-

terminated in accordance with subsection (b) of this section, the tax imposed pursuant to such subsection is to apply.

(b) *Alternative tax.*—Subsection (b) of section 877 contains special rules for the determination of an alternative tax under section 1 or 1201(b) of the code in the case of nonresident alien individuals who are expatriate U.S. citizens to whom subsection (a) of this section applies. In determining taxable income for purposes of this alternative tax, paragraph (1) provides that the gross income includes the gross income derived from sources within the United States which is not effectively connected with the conduct of a trade or business within the United States plus the gross income derived from sources within and without the United States which is effectively connected with the conduct of a trade or business within the United States, except that the special source rules of subsection (c) of this section shall also apply. For this purpose the determination of the source of income is to be made under the rules of sections 861 through 863 of the code, as amended by section 2 of the bill, to the extent such rules are not inconsistent with the special source rules contained in subsection (c) of this section.

Under paragraph (2) deductions allowable under subtitle A of the code are to be deducted from the gross income so determined, but only if and to the extent that such deductions are connected with the gross income so determined, and the proper allocation and apportionment of deductions for this purpose is to be determined under regulations prescribed by the Secretary of the Treasury or his delegate. No deduction is allowed, however, for the capital loss carryover provided by section 1212(b) of the code. The following deductions are specifically allowed by paragraph (2), whether or not they are connected with income from sources within the United States or with income which is effectively connected with the conduct of a trade or business within the United States and whether or not the nonresident alien individual is engaged in trade or business within the United States:

(1) The deduction for theft and casualty losses of nonbusiness property, as allowed by section 165(c)(3), if such property is located in the United States at the time of loss;

(2) The deduction for charitable contributions and gifts, as provided by section 170 of the code;

(3) One personal exemption allowed by section 151 of the code, except that an expatriate citizen who is a resident of Canada or Mexico may take all the exemptions available to him under section 151; and

(4) The deduction for losses not connected with a trade or business if incurred in a transaction entered into for profit, as allowed by section 165(c)(2) of the code, but only if the profit on such transaction, had such transaction resulted in a profit, would be included in gross income pursuant to paragraph (1) of this subsection.

In applying the limitations under section 170(b) of the code for purposes of determining the alternative tax imposed pursuant to subsection (b) of this section, the adjusted gross income is to be determined under sections 62 and 170(b) of the code after taking into account the gross income determined under this subsection.

A nonresident alien individual determining the alternative tax under subsection (b) may not take the standard deduction provided by section 141 of the code or use the tax table prescribed by section 3 of the code. The term "nonresident alien individual" as used in other sections of the code, includes a nonresident alien individual to whom section 877 applies.

(c) *Special rules of source.*—Subsection (c) of section 877 contains special rules of source which are used in determining the gross income of an individual to whom subsection (b) applies.

Sale of property

Paragraph (1) of section 877(c) provides that, for purposes of section 877(b), all gain, profits, and income from the sale or exchange of property located in the United States at the time of such sale or exchange is income from sources within the United States. This rule applies to all property, other than stock in a corporation or debt obligations, whether such property is real or personal, tangible or intangible.

Stock or debt obligations

Paragraph (2) of section 877(c) provides that, for purposes of section 877(b), any gain from the sale or exchange of the following property is income from sources within the United States: Stock issued by a domestic corporation; debt obligations of a U.S. person (as defined in section 7701(a)(30) of the code); and debt obligations of the United States, a State or political subdivision of a State, or the District of Columbia. For this purpose the actual location of such stock or debt obligations (or evidence of indebtedness) at the time of the sale or exchange is immaterial. A debt obligation is to be considered an obligation of a United States person, the United States, a State or political subdivision of a State, or the District of Columbia, only if such person or political unit is the principal obligor under the terms of the obligation.

(d) *Exception for loss of citizenship for certain causes.*—Subsection (d) of section 877 provides that the alternative tax imposed pursuant to subsection (a), and determined pursuant to subsections (b) and (c), does not apply to an expatriate U.S. citizen whose loss of such 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). Section 301(b) of that act provides that certain individuals who are born outside the United States of parents one of whom is an alien shall lose their U.S. citizenship if, within a specified period following the date of birth, they fail to be continuously physically present in the United States for at least 5 consecutive years. Section 350 of that act provides that under certain circumstances an individual who at birth acquires U.S. citizenship and citizenship of a foreign country and who claims the benefit of his foreign citizenship shall lose his U.S. citizenship if, after he has attained the age of 22 years, he maintains a continuous residence for 3 years in the country of his foreign citizenship. Section 355 of that act provides that under certain circumstances a U.S. citizen who is under 21 years of age and whose residence is in a foreign country with a parent who loses U.S. citizenship for specified causes shall lose his U.S. citizenship if he acquires the citizenship of such foreign country.

(e) *Burden of proof.*—Subsection (e) of section 877 provides that, in determining whether a principal purpose for the loss of U.S. citizenship by an expatriate citizen was the avoidance of U.S. income, gift, or estate taxes, the Secretary of the Treasury or his delegate must first establish that it is reasonable to believe that the loss of U.S. citizenship would, but for section 877, result in a substantial reduction, for the taxable year in respect of which section 877 is being applied, in the taxes (domestic and foreign) on his probable income for such year from all sources. In establishing this, the Secretary or his delegate may, in the absence of factual information concerning the individual's income from all sources during the taxable year, determine the tax on the probable income of such individual, as determined on the basis of information available to the Secretary. The probable income may, in appropriate cases, be determined on the basis of the individual's income for the preceding taxable year. The individual concerned may refute the Secretary's determination concerning such probable income, by showing what his income for the period actually was.

The Secretary or his delegate, in the absence of the actual income tax liability of the expatriate U.S. citizen to the foreign country of which he is a citizen or resident, will be considered to have established that it is reasonable to believe that a substantial tax reduction resulted from such individual's loss of U.S. citizenship if it is shown that, under the laws of the foreign country of which such individual is a citizen or resident, such individual could be expected to pay an income tax for the taxable year substantially lower than the income tax which he would have paid had he remained a citizen of the United States during such year. For this purpose, only those taxes imposed by the foreign country of which the expatriate is a citizen or resident which are income taxes, or taxes in lieu of income taxes, and taxes imposed by the United States will be taken into account. If under the foreign country's taxation system the political subdivisions of such country impose income taxes, such taxes shall also be taken into account in determining the expatriate's taxes on his probable income.

Once it has been established that it is reasonable to believe that such taxes (domestic and foreign) of the expatriate U.S. citizen on his probable income are less as a result of his loss of U.S. citizenship than they would be had he remained a citizen of the United States, such individual has the burden of proving that the principal purpose of such loss of citizenship was not the avoidance of U.S. income, gift, or estate taxes.

SECTION 3 OF BILL—CONTINUED

(f) *Partial exclusion of dividends.*—Subsection (f) of section 3 of the bill amends section 116(d) of the code (relating to certain non-resident alien individuals ineligible for the dividend exclusion) by providing that the \$100 dividend exclusion provided by section 116(a) applies only in determining (1) the graduated tax imposed on the income of a nonresident alien individual pursuant to amended section 871(b), if the dividends with respect to which the exclusion is claimed are effectively connected with the conduct of a trade or business within the United States, or (2) the graduated tax imposed on

the income of an expatriate U.S. citizen pursuant to section 877(b), as added by section 3(e) of the bill. Citizens of possessions of the United States who are taxed pursuant to section 932 of the code, as amended by section 3(m) of the bill, and who therefore determine their taxes in the manner prescribed by amended section 871 or new section 877(b), are also entitled in accordance with this subsection to the exclusion provided by section 116(a). The amendments provided by section 3(f) of the bill are effective for taxable years beginning after December 31, 1966.

(g) *Withholding of tax on nonresident aliens.*—Subsection (g) of section 3 of the bill amends section 1441 of the code (relating to the withholding of tax on nonresident alien individuals). The amendment is effective for taxable years beginning after December 31, 1966.

Under existing section 1441, persons having the control, receipt, custody, disposal, or payment of certain enumerated items of gross income, such as dividends, interest, and rents, from sources within the United States are required to withhold a tax of 30 percent when such amounts are paid to or for nonresident alien individuals, or any partnership not engaged in trade or business within the United States and composed in whole, or in part, of nonresident alien individuals. A special tax of 14 percent is withheld in the case of certain scholarship and fellowship grants and certain expense reimbursements incident thereto.

Paragraph (1) of section 3(g) of the bill amends section 1441(b) to conform that section to the amendments of section 861 made by section 2(a)(1) of the bill. Thus, for example, interest on deposits in the United States with persons carrying on the banking business will not be subject to withholding under section 1441(a) if such interest is received by a nonresident alien individual or foreign corporation and is not effectively connected with the conduct of a trade or business within the United States. In the case of such interest paid after December 31, 1971, however, withholding will be required. Paragraph (2) of section 3(g) amends section 1441(b) to conform that section to section 871(a)(1), as amended by section 3(a) of the bill.

Paragraph (3) of section 3(g) adds a new paragraph (1) to section 1441(c) in lieu of the existing paragraph (1) of such section. The new paragraph (1) provides that no withholding is required under section 1441(a) with respect to any income which is effectively connected with the conduct of a trade or business within the United States by the recipient individual, if for the taxable year of such recipient a tax is imposed on such income pursuant to section 871(b), as amended by section 3(a) of the bill.

This exception from withholding also applies to income from real property which, pursuant to an election under section 871(d), as amended by section 3(a) of the bill, is treated as income which is effectively connected with the conduct of a trade or business within the United States, but it does not apply to any income received as compensation for personal services, such income being subject to the provisions of amended section 1441(c)(4). It is anticipated that regulations prescribed by the Secretary or his delegate will provide for the furnishing of a statement or form to the withholding agent in order to identify income which is effectively connected with the

conduct of a trade or business within the United States on which a tax is imposed for the taxable year pursuant to amended section 871 (b). Individuals exempt from withholding under new paragraph (1) are required to make a declaration of estimated income tax, as provided in section 6015(i) (2) of the code, as amended by section 3(i) of the bill. Existing paragraph (1) of section 1441(c) is deleted by paragraph (3) of section 3(g) of the bill, so that all dividends paid by a foreign corporation will be subject to withholding under section 1441(a) to the extent such dividends are from sources within the United States under section 861(a) (2) (B), as amended by sections 2(b) (1) of the bill, and are not effectively connected with the conduct of a trade or business within the United States.

Paragraph (4) of section 3(g) of the bill amends paragraph (4) of section 1441(c). Amended paragraph (4) provides that compensation for personal services may be exempted from withholding under section 1441(a) pursuant to regulations prescribed by the Secretary of the Treasury or his delegate. This amendment is correlated with a similar amendment of section 3401(a) (relating to collection of income tax at source on wages) by section 3(k) of the bill. Existing section 1441(c) (4) provides for the exemption, pursuant to regulations, from withholding on compensation for personal services of nonresident aliens who enter and leave the United States at frequent intervals or who are temporarily present in the United States under subparagraph (F) or (J) of section 101(a) (15) of the Immigration and Nationality Act. It is anticipated that regulations to be prescribed under amended paragraph (4) will continue exemptions presently accorded by regulations under that paragraph and, in general, will exempt from withholding under chapter 3 any other compensation of a nonresident alien individual upon which withholding will be required under chapter 24 of the code.

Paragraph (5) of section 3(g) amends paragraph (5) of section 1441(c) in order to conform to section 871(a) (1), as amended by section 3(a) of the bill.

(h) *Liability for withheld tax.*—Subsection (h) of section 3 of the bill amends section 1461 of the code (relating to liability for withheld tax) to remove the provision requiring the annual return and payment of amounts withheld pursuant to the provisions of chapter 3 of the code. New return and payment requirements will be in accordance with the provisions of sections 6011(a), 6091(a), and 6151(a) of the code. The Secretary of the Treasury or his delegate may authorize under section 6302(c) the use of Government depositaries in respect of such tax, if circumstances warrant the use of such procedure. The amendment applies with respect to payments occurring after December 31, 1966.

(i) *Declaration of estimated income tax by individuals.*—Subsection (i) of section 3 of the bill amends section 6015 of the code (relating to declaration of estimated income tax by individuals). The amendment is effective for taxable years beginning after December 31, 1966. Under existing section 6015(a) only those nonresident alien individuals who are subject to withholding on wages under section 3402 of the code, or who are, or expect to be, residents of Puerto Rico for the entire taxable year, are required to make a declaration of esti-

mated tax. Under section 6015(i), as amended by this subsection, a declaration of estimated income tax is required of a nonresident alien individual who (1) is subject to withholding on wages under section 3402; (2) has income (other than compensation for personal services which is subject to withholding under sec. 1441) which is effectively connected with the conduct of a trade or business within the United States; or (3) is, or expects to be, a resident of Puerto Rico during the entire taxable year. Section 6015(i) (2), as amended, also applies to a nonresident alien individual whose income from real property is treated, pursuant to an election under amended section 871(d), as income which is effectively connected with the conduct of a trade or business within the United States.

(j) *Gain from dispositions of certain depreciable realty.*—Subsection (j) of section 3 of the bill amends paragraph (3) of section 1250(d) of the code (relating to certain tax free transactions). The amendment is effective for taxable years beginning after December 31, 1966. Under present paragraph (3) of section 1250(d) a transferor disposing of depreciable real property described in section 1250(c), in a transfer to which section 332, 351, 361, 371(a), 374(a), 721, or 731 of the code applies, is subject to the non-capital-gain treatment provided by section 1250(a) (1) only if, and to the extent that, gain is recognized to the transferor on the transfer. The amendment made in paragraph (3) of section 1250(d) by this subsection provides, in effect, that if a nonresident alien individual, a foreign estate or trust, or a foreign partnership transfers section 1250 property to a domestic corporation in exchange for stock or securities in such corporation in a section 351 transaction, the amount of resulting gain is subject to the provisions of section 1250(a) (1) irrespective of the amount of gain recognized to the transferor under section 351 on the transfer.

(k) *Collection of income tax at source on wages.*—Subsection (k) of section 3 of the bill amends section 3401(a) of the code (relating to the definition of wages for purposes of collection of income tax at source) by striking out paragraphs (6) and (7) which except the remuneration for services performed by certain nonresident alien individuals from the withholding requirement and inserting a new paragraph (6). The amendment is effective with respect to remuneration paid after December 31, 1966. The new paragraph (6) excepts from the term "wages" only such remuneration paid for the services performed by a nonresident alien individual as is designated by regulations prescribed by the Secretary of the Treasury or his delegate. This amendment is correlated with the amendment of section 1441(c) (4) made by section 3(g) of the bill with respect to withholding under chapter 3 of the code from the compensation for personal services of a nonresident alien individual. It is anticipated that regulations under amended paragraph (6) will continue exemptions presently accorded by regulations under existing section 3401(a) (6) and (7) and will extend withholding under chapter 24 of the code to certain compensation of nonresident alien individuals which is now subject to withholding under chapter 3. Remuneration of a nonresident alien individual which is made subject to withholding under chapter 24 will be exempt from withholding under chapter 3.

(l) *Definition of foreign estate or trust.*—Subsection (1) of section 3 of the bill contains a conforming amendment of section 7701(a) (31) of the code (defining foreign estate or trust). The amendment is effective for taxable years beginning after December 31, 1966. Existing paragraph (31) defines a foreign estate or trust as an estate or trust the income of which from sources without the United States is not includible in gross income under subtitle A. This is correlated with existing section 872(a) of the code, which provides that the gross income of a nonresident alien individual includes only the gross income from sources within the United States. A conforming amendment in the definition of a foreign estate or trust is necessary, since under section 872(a) (2), as amended by section 3(b) (1) of the bill, a nonresident alien individual must include in gross income the income from sources without the United States which is effectively connected with the conduct of a trade or business within the United States.

(m) *Conforming amendment.*—Subsection (m) of section 3 of the bill contains a conforming amendment to section 932(a) of the code (relating to citizens of possessions of the United States). The amendment is effective for taxable years beginning after December 31, 1966. As amended, section 932(a) continues the substance of existing law by providing that citizens of a possession of the United States, other than Puerto Rico, who are not otherwise citizens of the United States, are to be taxed in the same manner as nonresident alien individuals.

(n) *Effective dates.*—Subsection (n) of section 3 of the bill provides the effective dates for the several provisions of such section. Paragraph (1) provides that the provisions of section 3, other than the amendments made by subsections (h) and (k), apply with respect to taxable years beginning after December 31, 1966. Paragraph (2) provides that the amendments made by subsection (h) (relating to liability for taxes withheld under ch. 3) apply with respect to payments occurring after December 31, 1966. Paragraph (3) provides that the amendments made by subsection (k) (relating to withholding on wages under ch. 24) apply to remuneration paid after December 31, 1966. By reason of the provisions of section 861(c), as added by section 2(a) (1) (B) of the bill, amended section 861(a) (1) (A) and new section 861(c) will cease to apply with respect to amounts paid or credited after December 31, 1971.

SECTION 4 OF BILL. FOREIGN CORPORATIONS

(a) *Tax on income not connected with United States business.*—Subsection (a) of section 4 of the bill amends section 881 of the code. The amendment is effective for taxable years beginning after December 31, 1966. Existing section 881 applies only to foreign corporations not engaged in trade or business in the United States at any time during the taxable year. Such corporations are presently subject to a flat tax of 30 percent on all fixed or determinable annual or periodical income derived from sources within the United States and on amounts described in section 631 (b) and (c) of the code (relating to certain disposals of timber, coal, or iron ore) which are considered to be gains from the sale or exchange of capital assets and are derived from sources within the United States.

CODE SECTION 881. INCOME OF FOREIGN CORPORATIONS NOT CONNECTED
WITH UNITED STATES BUSINESS

(a) *Imposition of tax.*—Subsection (a) of section 881 of the code, as amended by section 4(a) of the bill, imposes a tax of 30 percent on substantially the same income from sources within the United States as that which is taxed at 30 percent under existing section 881(a), but the tax under amended section 881(a) is imposed only to the extent the income is not effectively connected with the conduct of a trade or business within the United States. Subsection (a) of amended section 881 applies to the items of income enumerated therein whether or not the corporation is engaged in trade or business in the United States during the taxable year for which the tax is being determined; but, if the corporation is not so engaged, under section 864(c)(1)(B), as added by section 2(d) of the bill, none of its income shall be treated as effectively connected with the conduct of a trade or business within the United States even though such income is attributable to a trade or business carried on in the United States by the recipient in a previous taxable year. Thus, in the case of a foreign corporation not engaged in trade or business at any time during the taxable year, a 30-percent tax is imposed by amended section 881(a) upon the items of income enumerated therein which are received from sources within the United States; no other tax is imposed for the taxable year.

Paragraphs (1), (2), and (3) of section 881(a) specify the income to which section 881(a) applies. The items of income described in paragraph (1) are also described in existing section 881(a), but the parenthetical expression containing a reference to interest on bank deposits has been eliminated. Paragraph (2) includes gains described in section 631(b) and (c), but section 1231 is not taken into account in determining the amount subject to tax. Paragraph (3) describes two items of income which are also subject to the 30-percent tax but which are not described in existing section 881(a). They are amounts which under section 341 of the code, or which under section 1232 of the code (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. None of the amounts described in paragraphs (1), (2), and (3) are subject to the 30-percent tax unless they are from sources within the United States. Gains from the sale or exchange of a capital asset (other than amounts to which amended sec. 881(a) (2) and (3) applies) are subject to tax only if they are received by a foreign corporation which is engaged in trade or business within the United States at some time during the taxable year for which the tax is being determined and are effectively connected with the conduct of a trade or business within the United States.

(b) *Doubling of tax.*—Subsection (b) of section 881 contains a cross reference to section 891 of the code (relating to doubling of tax on corporations of certain foreign countries).

SECTION 4 OF BILL—CONTINUED

(b) *Tax on income connected with United States business.*—Paragraph (1) of section 4(b) of the bill amends section 882 of the code (relating to tax on resident foreign corporations), and paragraphs

(2) and (3) of section 4(b) make certain technical or conforming amendments. The amendments are effective for taxable years beginning after December 31, 1966.

Under existing law a foreign corporation engaged in trade or business within the United States at any time during the taxable year is subject to the tax imposed by section 11 or 1201(a) of the code on all of its income derived from sources within the United States. Except in the case of the charitable deduction allowed by section 170, deductions are allowed in computing taxable income only to the extent that they are connected with income from sources within the United States. No foreign tax credit is allowed a foreign corporation under existing law.

CODE SECTION 882. INCOME OF FOREIGN CORPORATIONS CONNECTED WITH UNITED STATES BUSINESS

(a) *Normal tax and surtax.*—Subsection (a) of section 882, as amended by section 4(b) of this bill, concerns the imposition of tax on income which is effectively connected with the conduct of a trade or business within the United States.

Imposition of tax

Paragraph (1) of section 882(a) provides that a foreign corporation which is engaged in trade or business within the United States at any time during the taxable year in respect of which the tax is being determined is also subject to the regular corporate tax imposed by section 11 or 1201(a) on its taxable income (whether derived from sources within or without the United States) which is effectively connected with the conduct of a trade or business within the United States.

The determination of when income is effectively connected with the conduct of a trade or business within the United States, and of what income from sources without the United States is taken into account for such purpose, is to be made in accordance with section 864(c), as added by section 2(d) of the bill. A foreign corporation which is engaged in trade or business in the United States during the taxable year is also subject to the tax imposed by amended section 881 on its income from sources within the United States which is described in section 881(a) and which is not effectively connected with the conduct of a trade or business within the United States.

Paragraph (2) of section 882(a) provides that in determining the amount of 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. In determining the taxable income subject to tax under section 11 or 1201(a), no income is to be taken into account which is required to be taken into account in determining the tax under section 881.

(b) *Gross income.*—Subsection (b) of section 882 provides that in the case of a foreign corporation gross income includes only the income from United States sources which is not effectively connected with the conduct of a trade or business within the United States and all income (whether or not derived from sources within the United States) which is effectively connected with the conduct of a trade or business within the United States.

Income from sources within the United States which is not effectively connected with the conduct of a trade or business within the United States is taxable under section 881 of the code, as amended by section 4 (a) of the bill, if such income is described in section 881 (a). Any such income which is not described in section 881 (a), such as almost all capital gains, is not subject to U.S. income tax.

(c) *Allowance of deductions and credits.*—Subsection (c) of section 882 contains the rules applicable to the allowance of deductions and credits to a foreign corporation.

Allocation of deductions

Paragraph (1) (A) of section 882 (c) provides that generally the deductions allowed under subtitle A (relating to income taxes) of the code are allowed to a foreign corporation only if and to the extent that such deductions are connected with income which is effectively connected with the conduct of a trade or business within the United States; moreover, such deductions are allowed only for purposes of determining under section 882 (a) the tax on taxable income which is effectively connected with the conduct of a trade or business within the United States. The Secretary of the Treasury or his delegate is authorized to prescribe by regulations the proper apportionment and allocation of the deductions for such purposes. The deductions allowed by section 882(c) may in no case be used to reduce amounts subject to the 30-percent tax imposed by section 881.

Paragraph (1) (B) of section 882(c) provides that, in determining the tax imposed pursuant to section 882(a), a foreign corporation may take the deduction for charitable contributions and gifts allowed by section 170 of the code whether or not such deduction is connected with income which is effectively connected with the conduct of a trade or business within the United States. In determining the limitations on the amount of the deduction pursuant to section 170(b), only the gross income which is effectively connected with the conduct of a trade or business within the United States is to be taken into account.

For a more detailed discussion of the allowance of deductions, see the comments on section 873, as amended by section 3(c) of the bill.

The provisions of amended section 882 may be illustrated by the following example:

Example

During the taxable year, foreign corporation M maintains a branch sales office in the United States and by reason of its activities therein is engaged in business within the United States. The income which is effectively connected with the business carried on through such sales office is derived from sources within the United States. Corporation M also owns stock in a domestic corporation, and, by reason of the application of new section 864(c), the dividends on such stock, and a capital gain derived from the sale of a part of the stock, are not effectively connected with the conduct of the trade or business within the United States. The tax under section 11 of the code is imposed on the taxable income which is effectively connected with the business carried on through such sales office, determined after allowance of all deductions connected with income which is effectively connected with the conduct of the trade or business within the United

States. The tax of 30 perent is imposed under section 881 on the gross amount of the dividend income. The gain realized from the sale of stock is not subject to U.S. income tax.

Deductions and credits allowed only if return filed

Paragraph (2) of section 882(c) continues the substance of the rule contained in section 882(c)(1) of existing law that a foreign corporation is to receive the benefit of the allowable deductions only by filing a true and accurate return of its total income (including income subject to tax under section 881(a)); a technical amendment has been provided, however, to make clear that the return must also include the income derived from sources without the United States which is effectively connected with the conduct of a trade or business within the United States. This rule has also been extended to apply to credits against tax, such as the foreign tax credit, other than the credit provided by section 32 for tax withheld at the source or the credit provided by section 39 for certain users of gasoline and lubricating oil. As so amended, section 882(c)(2) is consistent with section 874(a) of the code, as amended by section 3(d) of the bill.

Foreign tax credit

Paragraph (3) of section 882(c) provides that a foreign corporation will not be allowed the foreign tax credit allowed under section 901 of the code, except to the extent provided by section 906 of the code, as added by section 6(a) of the bill. Under existing law a foreign corporation is not allowed a foreign tax credit.

Cross reference

Paragraph (4) of section 882(c) contains a cross reference to section 906(b)(1) of the code, as added by section 6(a) of the bill, relating to the limitation on the amount of the credit under section 906(a) or, if applicable, the amount of any deduction under section 882(c), for income taxes paid or accrued to any foreign country or possession of the United States.

(d) *Election to treat real property income as income connected with United States business.*—Subsection (d) of section 882 permits a foreign corporation deriving real property income from sources within the United States which is not effectively connected with the conduct of a trade or business within the United States to elect to treat such income as income which is effectively connected with the conduct of a trade or business within the United States; the income which is so treated is taxable in accordance with the provisions of section 882(a). The election is available to all foreign corporations, whether or not engaged in trade or business within the United States during the taxable year for which the election is made or during taxable years for which the election is in effect. The provisions relating to the applicability of such an election, as well as the manner of making or revoking the election, are identical to the provisions of section 871(d), as amended by section 3(a) of the bill. See the discussion of amended section 871(d).

(e) *Returns of tax by agent.*—Subsection (e) of section 882 continues the rule of existing section 882(d) of the code, which provides that, if a foreign corporation has no office or place of business in the

United States but has an agent in the United States, the corporation's return which is required by section 6012 of the code is to be made by such agent.

SECTION 4 OF BILL—CONTINUED

(c) *Withholding of tax on foreign corporations.*—Subsection (c) of section 4 of the bill amends section 1442 of the code (relating to withholding of tax on foreign corporations), effective with respect to taxable years beginning after December 31, 1966. Under existing law a foreign corporation not engaged in trade or business within the United States is generally subject to the withholding of tax under chapter 3 of the code in the same manner as a nonresident alien individual; and, subject to specified rules, such corporation is also subject to the withholding of tax under section 1451 (relating to interest on tax-free covenant bonds). A foreign corporation engaged in trade or business within the United States is presently not subject to withholding of tax under such sections.

CODE SECTION 1442. WITHHOLDING OF TAX ON FOREIGN CORPORATIONS

(a) *General rule.*—Subsection (a) of section 1442, as amended by section 4(c) of the bill, places foreign corporations engaged in a trade or business within the United States in the same status as nonresident alien individuals engaged in trade or business within the United States with respect to the withholding of tax provided by section 1441.

Thus, foreign corporations engaged in a trade or business within the United States will be subject to withholding at the 30-percent rate of tax only on items of income from sources within the United States designated in section 1441(b), as amended by section 3(g) of the bill, which are not effectively connected with the conduct of a trade or business within the United States. Income (other than income for services) which is effectively connected with the conduct of a trade or business within the United States is not subject to withholding of tax under section 1442(a) if a tax is imposed on such income for the taxable year of the recipient pursuant to amended section 882(a)(1), or, if applicable, pursuant to amended section 842. By reason of amended section 1441(c)(4), income for services performed by a foreign corporation may be exempted from withholding under section 1442(a) pursuant to regulations prescribed by the Secretary of the Treasury or his delegate. No change is made in section 1451, with the result that only a foreign corporation not engaged in a trade or business in the United States is subject to the withholding of tax under such section from interest on tax-free covenant bonds, whether or not such interest is effectively connected with the conduct of a trade or business within the United States.

(b) *Exemption.*—Subsection (b) of section 1442 provides that, subject to such terms and conditions as may be provided by regulations, a foreign corporation engaged in trade or business within the United States at some time during the taxable year may be exempted from withholding under subsection (a) if the Secretary of the Treasury or his delegate determines that the withholding requirements of subsection (a) impose an undue administrative burden and that the collection of the flat 30-percent tax imposed by amended section 881

(relating to income not connected with a U.S. business) on such corporation will not be jeopardized by the exemption. The Secretary or his delegate is authorized to prescribe by regulations the terms and conditions pursuant to which a foreign corporation may be exempted from withholding under subsection (a). The terms and conditions so prescribed may be such as to insure that the tax imposed by section 881 on the income of the foreign corporation is returned and paid by the exempted foreign corporation, no later than the date such amounts would be returned and paid by the withholding agent if the exemption from withholding had not been granted.

SECTION 4 OF BILL—CONTINUED

(d) *Dividends received from certain foreign corporations.*—Subsection (d) of section 4 of the bill amends section 245 of the code (relating to the allowance of a deduction for dividends received from a foreign corporation). The amendment is effective for taxable years beginning after December 31, 1966. Under existing law a corporation, whether domestic or foreign, receiving dividends from a foreign corporation which, for the specified 36-month period, is engaged in trade or business in the United States and derives 50 percent or more of its gross income from sources within the United States is entitled, if the deduction is otherwise allowable, to take as a deduction a pro rata portion of 85 percent of the dividends received from the foreign corporation paying the dividends. The pro rata portion is based on the ratio which the paying corporation's gross income from sources within the United States bears to its gross income from all sources.

The amendments made by paragraphs (1), (2), and (3) of section 4(d) of the bill strike out of section 245(a) all references to income from sources within the United States and substitute references to income effectively connected with the conduct of a trade or business within the United States. These amendments are necessary to conform section 245 to the amended taxing provisions applicable to foreign corporations and operate to continue the principle of the existing provision. Thus, the deduction for dividends received from a foreign corporation, when otherwise allowable, is to be allowed if 50 percent or more of the total gross income of such foreign corporation from all sources for the applicable period is effectively connected with the conduct of a trade or business within the United States. The amount of the deduction is determined as under existing law, but the pro rata portion is based upon the ratio which the gross income which is effectively connected with the conduct of a trade or business within the United States bears to such corporation's total gross income from all sources.

Paragraph (4) of section 4(d) of the bill provides in effect that, to the extent gross income of the foreign corporation for any period before its first taxable year beginning after December 31, 1966, is required to be taken into account for purposes of applying amended section 245, the gross income of such corporation for such period from sources within the United States will be considered to be gross income effectively connected with the conduct of a trade or business within the United States.

(e) *Unrelated business taxable income.*—Subsection (e) of section 4 of the bill amends section 512(a) of the code (relating to the definition of “unrelated business taxable income”) to provide that, in the case of a foreign organization of the type described in section 511 of the code (relating to charitable, etc., organizations), the unrelated business taxable income includes only the unrelated business taxable income which is effectively connected with the conduct of a trade or business within the United States. The amendment is effective for taxable years beginning after December 31, 1966.

(f) *Corporations subject to personal holding company tax.*—Subsection (f) of section 4 of the bill amends section 542(c) (7) of the code (relating to foreign corporations not subject to the personal holding company tax) by deleting the 50-percent gross income test of existing paragraph (7) (A) and by making existing paragraph (7) (B), with certain modifications, paragraph (7). The amendment is effective for taxable years beginning after December 31, 1966. Under this amendment, the term “personal holding company” does not include a foreign corporation all of whose outstanding stock during the last half of the taxable year is owned by nonresident alien individuals directly or indirectly through foreign estates, foreign trusts, foreign partnerships, or other foreign corporations. For this purpose, stock will be considered as owned by nonresident alien individuals indirectly through foreign estates, foreign trusts, foreign partnerships, or foreign corporations if all of the beneficiaries (having an interest with an actuarial value of 5 percent or more), partners, or shareholders of such estates, trusts, partnerships, or corporations are nonresident alien individuals.

(g) *Amendments with respect to foreign corporations carrying on insurance business in United States.*—Subsection (g) of section 4 of the bill amends those provisions of subchapter L of chapter 1 of the code (relating to insurance companies) that apply to foreign corporations. The amendments are effective for taxable years beginning after December 31, 1966.

In general

Paragraph (1) of section 4(g) of the bill deletes present section 842 of the code (relating to computation of gross income) and adds a new section 842.

Existing section 842 provides that the gross income of a life insurance company subject to the tax imposed by section 802, and of the mutual marine, etc., insurance companies subject to the tax imposed by section 831, is not to be determined in the manner provided in sections 861 through 864 of the code, relating to the determination of sources of income.

CODE SECTION 842. FOREIGN CORPORATIONS CARRYING ON INSURANCE BUSINESS

New section 842 replaces all of the existing provisions in parts I, II, and III of subchapter L which designate when and to what extent a foreign insurance company will be subject to the tax imposed pursuant to those parts. The coordinating amendments to conform to this change are embodied in the other paragraphs of section 4(g)

of the bill. Under new section 842, only those foreign corporations carrying on an insurance business in the United States are subject to the provisions of subchapter L which, were they domestic corporations, would qualify for the taxable year under part I, II, or III of such subchapter without taking into account their income not effectively connected with the conduct of a trade or business within the United States.

Each such corporation which would so qualify for the taxable year under either part I, II, or III of subchapter L shall be taxable for such year under that part on its entire taxable income (whether derived from sources within or without the United States) which is effectively connected with its conduct of any trade or business (whether or not its insurance business) within the United States. In determining such taxable income, only allowable deductions which are connected with income which is effectively connected with the conduct of a trade or business within the United States are to be allowed.

Any income derived by such foreign corporation from sources within the United States which is not effectively connected with the conduct of any trade or business in the United States is taxed for such year as provided in section 881, as amended by section 4(a) of the bill.

Each such foreign corporation which would not so qualify for the taxable year under part I, II, or III of subchapter L, and all foreign insurance companies not carrying on an insurance business in the United States, shall be taxable as provided in amended section 881 or 882 with respect to other foreign corporations. In determining whether income is derived from sources within or without the United States for purposes of applying subchapter L, as amended by the bill, the provisions of sections 861 through 864 of the code shall apply. In determining for purposes of subchapter L whether a foreign corporation is carrying on an insurance business in the United States, and whether income is effectively connected with the conduct of a trade or business within the United States, section 864 (b) and (c), as added by section 2(d) of the bill, shall apply.

SECTION 4 OF BILL—CONTINUED

Clerical amendment

Paragraph (2) of section 4(g) of the bill amends the table of sections for part IV of subchapter L of chapter 1.

Life insurance companies

Paragraph (3) of section 4(g) of the bill provides various amendments of section 819 of the code (relating to foreign life insurance companies). Subparagraph (A) of paragraph (3) deletes subsections (a) (relating to foreign life insurance companies carrying on a life insurance business in the United States) and (d) (relating to foreign life insurance companies not carrying on an insurance business within the United States) from section 819 and redesignates subsections (b) and (c) of such section as subsections (a) and (b). Subparagraphs (B) through (H), except for subparagraph (D), of paragraph (3) make clerical changes in section 819 to conform it to the amendment made by subparagraph (A). Subparagraph (I) of para-

graph (3) adds a new subsection (c) to amended section 819 containing a cross reference to section 842.

Subparagraph (D) of paragraph (3) adds a new paragraph (3) to section 819(a), as redesignated by subparagraph (A), which provides for the reduction of the tax, if any, imposed under section 881, as amended by section 4(a) of the bill, during a taxable year for which the adjustment required by section 819(a)(1), as so redesignated, is required to be made. Amended section 819(a)(1), as does present law, provides for an adjustment in determining the tax imposed by part I (relating to life insurance companies) of subchapter L (secs. 801 et seq.) for taxable years during which the foreign corporation maintains a surplus in the United States which is less than the special minimum figure determined in accordance with paragraph (2) of amended section 819(a). The section 819(a)(1) adjustment consists of a reduction in the amount of policy and other contract liability requirements and in the amount of the required interest, thereby increasing the amount of tax imposed by part I of subchapter L.

The provisions of new paragraph (3) of section 819(a) provide, in effect, that in cases where the adjustment required by section 819(a)(1) is made with a resulting increase in the tax imposed by part I of subchapter L, a compensating adjustment shall be made by reducing the tax which is otherwise imposed by amended section 881 on the foreign corporation's income from sources within the United States which is not effectively connected with the conduct of a trade or business within the United States. This compensating reduction of the section 881 tax is accomplished by a formula which takes into account the fact that, by reason of exemptions and reductions in rate, the effective rate of the tax imposed by that section may be less than 30 percent.

In determining the reduction in the tax otherwise imposed by section 881 on the income of the foreign corporation which is required to make the section 819(a)(1) adjustment, paragraph (3) of such section provides that there shall first be determined: (1) The total amount of income which would be subject to the tax imposed by section 881 if such income were being determined without regard to the exclusions from gross income provided by sections 103 and 894, and (2) the amount determined under section 819(a)(1) by which the amount of the policy and other contract liability requirements and the amount of the required interest is reduced. The tax otherwise actually imposed by section 881 for the taxable year shall then be reduced by an amount which is the same proportion of such tax (before reduction) as such amount used for reduction purposes under section 819(a)(1) bears to the total amount of income so determined to be subject to tax under section 881. In no case, however, shall the tax otherwise imposed by section 881 be reduced below zero, nor shall the reduction in the tax otherwise imposed by section 881 exceed the increase in tax imposed by part I of subchapter L by reason of the reduction provided in paragraph (1) of section 819(a).

Mutual insurance companies

Paragraph (4) of section 4(g) of the bill amends section 821 of the code (relating to the tax on mutual insurance companies to which pt. II of subch. L applies). Subparagraph (A) of paragraph (4) strikes out subsection (e) of section 821 (relating to foreign

mutual insurance companies not carrying on an insurance business in the United States) and redesignates subsections (f) and (g) of such section as subsections (e) and (f). Subparagraph (B) of paragraph (4) adds a new paragraph (3), containing a cross reference to section 842, to newly designated section 821(f).

Paragraph (5) of section 4(g) of the bill amends section 822 (relating to the determination of taxable investment income) by striking out subsection (e) (relating to foreign mutual insurance companies carrying on an insurance business in the United States) and by redesignating subsection (f) as subsection (e).

Other insurance companies

Paragraph (6) of section 4(g) of the bill amends section 831 of the code (relating to tax on mutual marine, etc., insurance companies) by striking out subsection (b) (relating to foreign mutual marine, etc., insurance companies not carrying on an insurance business in the United States), by redesignating subsection (c) as subsection (b), and by redesignating subsection (d) as subsection (c) and adding therein a cross reference to section 842.

Paragraph (7) of section 4(g) amends section 832 (relating to insurance company taxable income) by striking out subsection (d) (relating to foreign mutual marine, etc., insurance companies carrying on an insurance business in the United States) and by redesignating subsection (e) as subsection (d).

Provisions of general application

Paragraph (8) of section 4(g) amends section 841 (relating to credit for foreign taxes) by making the definition of "taxable income" contained therein apply in the case of foreign corporations subject to tax under subchapter L which are entitled to the foreign tax credit determined as provided in section 906 of the code, as added by section 6(a) of the bill.

(h) *Subpart F income.*—Subsection (h) of section 4 of the bill amends section 952(b) of the code (relating to the exclusion of U.S. source income from subpart F income). The amendment is effective for taxable years beginning after December 31, 1966. Existing section 952(b) provides that income derived from sources within the United States by a controlled foreign corporation engaged in trade or business in the United States is excluded from subpart F income if such income from U.S. sources is includible in gross income of such corporation under any provisions (other than secs. 951 through 964) of chapter 1 of the code. The purpose of existing section 952(b) is to exclude from the application of sections 951 through 964 income which is otherwise subject to U.S. income tax under section 11 or 1201(a) by reason of being derived from sources in the United States.

Amended section 952(b) retains the principle of existing section 952(b) by providing that income from sources within the United States which is effectively connected with the conduct of a trade or business within the United States is excluded from subpart F income. Thus, for example, dividends received from sources within the United States by a foreign corporation engaged in trade or business within the United States, which are not effectively connected with the conduct of a trade or business within the United States are not excluded

from subpart F income under amended section 952(b), even though such dividends are subject to the tax imposed by amended section 881(a). Moreover if by reason of a treaty obligation of the United States the income from sources within the United States which is effectively connected with the conduct of a trade or business within the United States is not subject to the regular U.S. corporate rate of tax, such income is not excluded from subpart F income under amended section 952(b).

(i) *Gain from certain sales or exchanges of stock in certain foreign corporations.*—Subsection (i) of section 4 of the bill amends paragraph (4) of section 1248(d) of the code (relating to exclusions from earnings and profits of controlled foreign corporations for certain purposes). The amendment, which is effective with respect to sales or exchanges of stock occurring after December 31, 1966, continues the principle of the existing provision by providing that for taxable years beginning before January 1, 1967, income which is derived from sources within the United States by a foreign corporation engaged in trade or business in the United States and is includible in the gross income of such corporation is to be excluded from the earnings and profits of such corporation for purposes of determining the amount of tax imposed on a U.S. person pursuant to section 1248.

For taxable years beginning after December 31, 1966, income which is effectively connected with the conduct of a trade or business within the United States by a foreign corporation, whether derived from sources within or without the United States, and which is includible in the gross income of such corporation is to be excluded from its earnings and profits for purposes of applying section 1248 to a U.S. person. The exclusions provided by amended paragraph (4) are not to apply to any item of income which is exempt from U.S. tax, or is subject to a reduced rate of U.S. tax, by reason of a treaty obligation of the United States.

(j) *Declaration of estimated income tax by corporations.*—Subsection (j) of section 4 of the bill amends section 6016 of the code (relating to declarations of estimated income tax by corporations) by redesignating subsection (f) as subsection (g) and by inserting a new subsection (f). The amendment is effective for taxable years beginning after December 31, 1966. The new subsection (f) provides, in effect, that a foreign corporation subject to taxation under section 11 or 1201(a), or under subchapter L of chapter 1, must treat the tax imposed under section 881 as a tax imposed by section 11 in determining whether it must make a declaration of estimated tax and in determining the amount of the estimated tax.

Thus, in cases where the income subject to tax under section 881 has been withheld on pursuant to section 1442, as amended by section 4(c) of the bill, the credit under section 32 of the code for the tax withheld which is taken into account for purposes of section 6016 will effectively remove the section 881 tax from consideration for purposes of section 6016. If, however, any income subject to tax under section 881 has not been fully withheld on, the tax imposed by section 881 which is in excess of the credit allowed by section 32 will be taken into account in determining whether a declaration is required and will increase the estimated tax for the taxable year. On the other hand, if the tax imposed by section 881 is determined to be less than the credit allowed under section 32, such excess credit will be taken into

account in determining whether a declaration is required and will reduce the estimated tax for the taxable year.

The amendment made by this subsection also applies for purposes of section 6655 (relating to the addition to tax in the case of failure by a corporation to pay estimated tax).

(k) *Technical amendments.*—Paragraph (1) of section 4(k) of the bill amends section 884 of the code (relating to cross references).

Paragraph (2) of section 4(k) corrects an erroneous reference to section 832(b)(5) in section 953(b)(3)(F) of the code, as added by section 12(a) of the Revenue Act of 1962. The amended reference is to section 832(c)(5) of the code (relating to capital losses allowed in determining taxable income of an insurance company subject to the tax imposed by sec. 831).

Paragraph (3) of section 4(k) corrects a clerical error in section 1249(a) of the code, as added by section 16(a) of the Revenue Act of 1962.

The amendments made by section 4(k) of the bill are effective for taxable years beginning after December 31, 1966.

(l) *Effective dates.*—Subsection (1) of section 4 of the bill provides that the amendments made by section 4, other than by subsection (i), apply with respect to taxable years beginning after December 31, 1966. The amendment made by subsection (i) applies with respect to sales or exchanges occurring after December 31, 1966.

SECTION 5 OF BILL. SPECIAL TAX PROVISIONS

(a) *Income affected by treaty.*—Subsection (a) of section 5 of the bill designates the provisions of existing section 894 of the code (relating to income exempt under treaty) as new section 894(a) and adds a new subsection (b). The amendment is effective for taxable years beginning after December 31, 1966.

CODE SECTION 894. INCOME AFFECTED BY TREATY

(a) *Income exempt under treaty.*—Subsection (a) of section 894, as amended by section 5 (a) of the bill, is identical to existing section 894.

(b) *Permanent establishment in United States.*—Subsection (b) of section 894 provides that a nonresident alien individual or foreign corporation which is engaged in trade or business in the United States at any time during the taxable year is deemed not to have a permanent establishment within the United States during such year for purposes of applying any exemption from, or reduction in the rate of, any U.S. tax provided by any U.S. treaty with respect to income which is not effectively connected with the conduct of a trade or business within the United States.

This provision operates to extend such exemptions and reductions to nonresident alien individuals and foreign corporations even though they are engaged in trade or business in the United States through a permanent establishment situated therein; it will apply to all treaties entered into by the United States, whether entered into before, on, or after the date of enactment of the bill. Only those items of income derived from sources within the United States which are subject to the 30-percent tax imposed by section 871 (a) (in the case of a nonresident alien individual) or section 881 (in the case of a foreign corporation)

are affected by this provision. The provisions of section 894(b) do not apply in the case of a nonresident alien individual subject to the tax imposed pursuant to section 877(b) (relating to expatriation to avoid tax), as added by section 3(e) of the bill.

Without the amendment provided by section 894(b) a nonresident alien individual, or a foreign corporation, having a permanent establishment in the United States would be taxable at the flat 30-percent rate under amended section 871(a) or 881 on the gross income from sources within the United States which is not effectively connected with the conduct of a trade or business within the United States. Under existing law such a nonresident alien individual or foreign corporation is taxable at graduated rates under section 1 (or section 11) or 1201 on such income and the flat 30-percent tax on gross income does not apply. Section 894(b) extends to such a nonresident alien individual or foreign corporation the benefit of any exemption, or reduced rate of tax, under a treaty in the case of income from sources within the United States which is not effectively connected with the conduct of a trade or business within the United States.

The provisions of section 894(b) may be illustrated by the following example:

Example

M, a corporation organized in foreign country Z, is engaged in business in the United States through a permanent establishment located therein. The United States and country Z are parties to an income tax convention. The convention provides that the United States will tax at a 15-percent rate dividends received from sources within the United States by a corporation of country Z not having a permanent establishment in the United States. Corporation M receives dividends from a domestic corporation all of whose income is from U.S. sources. The dividends are not effectively connected with the conduct of M corporation's business in the United States. The gross dividends are taxable under amended section 881, but the tax may not exceed the treaty rate of 15 percent. If the dividends were effectively connected with the conduct of M corporation's business in the United States, they would be taxable under section 882(a) after allowance of the dividends-received deduction under section 243 of the code.

SECTION 5 OF BILL—CONTINUED

(b) *Application of pre-1967 income tax provisions.*—Subsection (b) of section 5 of the bill adds new section 896 to subpart C of part II of subchapter N of chapter 1 of the code (relating to miscellaneous provisions applicable to nonresident aliens and foreign corporations). The amendment is effective for taxable years beginning after December 31, 1966.

CODE SECTION 896. APPLICATION OF PRE-1967 INCOME TAX PROVISIONS

(a) *Imposition of more burdensome taxes by foreign country.*—Subsection (a) of section 896 contains procedures whereby the President can proclaim that the tax of certain nonresident alien individuals and foreign corporations will be determined under the provisions of subchapter N of chapter 1, and of chapter 3, of the code which were in effect immediately before the date of enactment of this bill. Before

making such a proclamation the President must make three specified findings.

Paragraph (1) of section 896(a) provides that the President must first find that a foreign country (taking into account taxes imposed by its political subdivisions) is imposing more burdensome taxes on income received from sources within that country by U.S. citizens not resident in that country or by domestic corporations not domiciled in that country than the United States imposes on similar income derived from sources within the United States by nonresident alien individuals resident in that country or by corporations of that country. This finding may be made with respect to individuals or corporations or both. It may be made with respect to any particular item of income, any combination of types of income, or all income.

Paragraph (2) of section 896(a) provides that the President must find that, after having been requested by the United States to do so, the foreign country has not acted to revise or reduce the more burdensome taxes (with respect to which the finding under par. (1) has been made) so as to alleviate the more burdensome taxes involved.

Paragraph (3) provides that the President must find that it is in the public interest to apply pre-1967 tax provisions to residents or corporations of that foreign country in accordance with this section.

After making the appropriate findings, the President shall proclaim that the tax of the nonresident alien individuals or foreign corporations involved will be determined in the manner provided by subsection (a) for taxable years beginning after the date the proclamation is issued. The proclamation will be limited to the foreign country, taxpayers, and income with respect to which the findings under paragraphs (1), (2), and (3) have been made.

(b) *Alleviation of more burdensome taxes.*—Subsection (b) of section 896 provides the procedure whereby the President may revoke a proclamation issued pursuant to the provisions of section 896(a). A proclamation issued under section 896(a) may be revoked completely or in part if the President finds that the conditions upon which the finding required by paragraph (1) of section 896(a) was made have been sufficiently remedied to justify a complete or partial revocation. If such a finding is made, the President may revoke the outstanding proclamation by so proclaiming. The revocation so made shall apply with respect to taxable years beginning after the date the revoking proclamation is issued, and for such taxable years the tax shall be determined under subtitle A without regard to section 896(a).

(c) *Notification of Congress required.*—Subsection (c) of section 896 requires the President to give Congress a 30-day notice of his intention to issue a proclamation under section 896(a) or to revoke a proclamation under section 896(b).

(d) *Implementation by regulations.*—Subsection (d) of section 896 authorizes the Secretary of the Treasury or his delegate to prescribe regulations to implement the provisions of section 896.

SECTION 5 OF BILL—CONTINUED

(c) *Clerical amendments.*—Subsection (c) of section 5 of the bill amends the table of sections for subpart C of part II of subchapter N of chapter 1 to conform to the amendments made by subsections (a) and (b) of section 5 of the bill.

(d) *Effective date.*—Subsection (d) of section 5 of the bill provides that the amendments made by section 5 of the bill apply to taxable years beginning after December 31, 1966.

(e) *Elections by nonresident United States citizens who are subject to foreign community property laws.*—Paragraph (1) of section 5(e) of the bill adds a new section 981 (designated as new subpart H) to part III of subchapter N of chapter 1 of the code (relating to income from sources without the United States).

CODE SECTION 981. ELECTION AS TO TREATMENT OF INCOME SUBJECT TO
FOREIGN COMMUNITY PROPERTY LAWS

(a) *General rule.*—Subsection (a) of new section 981 provides that for any taxable year beginning after December 31, 1966, an individual who is (1) a citizen of the United States, (2) a bona fide resident of a foreign country or countries during the entire taxable year, and (3) married at the close of the taxable year to an individual who is a nonresident alien during the entire taxable year, may, together with such spouse, elect for such year to have subsection (b) apply to their income for any taxable year in which there is community income under the community property laws of a foreign country. If an election to have subsection (b) apply for a taxable year has been made, the election is to apply for all open taxable years (as defined in subsection (e) (2)) for which the requirements of subsection (a) (1) are met, unless the Secretary of the Treasury or his delegate consents to a termination of the election.

(b) *Treatment of community income.*—Subsection (b) of new section 981 contains rules for determining the attribution of the community income to the respective spouses for U.S. income tax purposes for taxable years beginning after December 31, 1966, to which the election made under subsection (a) applies. Community income for this purpose means community income as determined under the community property laws of the foreign country of jurisdiction.

Earned income

Paragraph (1) of subsection (b) provides that wages, salaries, or professional fees, and other amounts received as compensation for personal services actually performed which, under the foreign community property laws is treated as community income of the spouses, are to be treated as the income of the spouse who actually performed the personal services. This rule does not apply to community income derived by a spouse from a trade or business conducted by such spouse in which both personal services and capital are material income-producing factors, nor does it apply to a partner's distributive share of partnership income. Also this rule does not apply to any compensation which represents a distribution of earnings or profits of a corporation rather than a reasonable allowance for compensation for personal services actually performed.

Trade or business income and partnership income

Paragraph (2) of subsection (b) contains a rule for the attribution to the respective spouses of the community income derived from a trade or business and of community income which is a partner's distributive share of partnership income. The rule follows the princi-

ples of section 1402(a)(5) of the code (relating to the definition of "net earnings from self-employment". For this purpose income derived from a trade or business includes the full amount of any community income realized from the conduct of a trade or business in which both personal services and capital are material income-producing factors, but does not include income realized from a trade or business carried on by a partnership. In accordance with the principles of section 1402(a)(5)(A), any of the community income realized from the conduct of a trade or business will generally be treated, for purposes of section 981(a), as the income of the husband. However, if it is shown that the wife exercises substantially all of the management and control over the trade or business, all of the community income realized from the trade or business is to be treated as the income of the wife.

In accordance with the principles of section 1402(a)(5)(B), any portion of a partner's distributive share of the income of a partnership which is community income is to be treated, for purposes of section 981(a), as the income of the spouse who is the partner entitled to receive such share.

Income from separate property

Paragraph (3) of subsection (b) provides that any community income which is not described in either paragraph (1) or (2) of such subsection and which is derived from separate property of one of the spouses (as determined under the community property laws of the foreign jurisdiction) is to be treated as income of the spouse whose separate property gave rise to such community income.

Other community income

Paragraph (4) of subsection (b) provides that all income which is community income under the community property laws of the foreign jurisdiction and which is not described in either paragraph (1), (2), or (3) of such subsection (e.g., community income derived from community property) is to be treated as the income of the spouse who is the owner of such income under the community property laws of such foreign jurisdiction.

(c) *Election for pre-1967 years.*—Subsection (c) of new section 981 contains provisions for the application of an elective procedure to taxable years beginning before January 1, 1967.

Election

Paragraph (1) of subsection (c) provides that an individual who meets the requirements of subsection (a)(1)(A) and (C) for any taxable year beginning before January 1, 1967, may, together with his spouse, elect, for all open taxable years beginning before January 1, 1967 (as defined in subsection (e)(2)), for which the requirements of subsection (a)(1)(A) and (C) are met, to have the provisions of paragraph (2) of subsection (c) apply for purposes of determining their U.S. income tax liability. The election is to be made jointly and is applied to each open taxable year beginning before January 1, 1967.

Except as provided in subsection (d)(3), an election to have subsection (c) apply for open taxable years beginning before January 1, 1967, must be made by both spouses described in subsection (a)(1)

(A) and (C). This is true whether or not the period, in the case of the nonresident alien spouse, for assessing a deficiency for a taxable year has otherwise expired at the time of the election. An election made pursuant to subsection (c) in no case is to be considered in effect for any taxable year beginning after December 31, 1966. Furthermore, an election under subsection (c) is not to apply for any taxable year for which the requirements of subsection (a) (1) (A) and (C) are not met.

In determining or redetermining the U.S. income tax of the U.S. citizen spouse, or of the nonresident alien spouse, for any such taxable year for which the election under subsection (c) applies, the provisions of the 1954 code, the 1939 code, or any earlier Revenue Act, whichever was applicable to such taxable year, is to apply.

For purposes of subsections (a) and (c) if the spouses have different taxable years, the period for which the income of the nonresident alien spouse is to be determined in accordance with paragraph (2) of subsection (c) is to be that period falling within 2 consecutive taxable years of the nonresident alien spouse which coincides with the period covered by the open taxable year of the U.S. citizen spouse.

Effect of election

Paragraph (2) of subsection (c) contains rules for the attribution of the community income to the respective spouses for U.S. income tax purposes for all taxable years for which the election made under subsection (c) applies. In general, income which is community income under the community property laws of the governing foreign jurisdiction is to be attributed to the respective spouses in accordance with the rules of subsection (b), which are the rules applicable to elections under subsection (a) for taxable years beginning after December 31, 1966. However, for any taxable year to which the election under subsection (c) applies, the rule of paragraph (4) of subsection (b) does not apply in the case of the election made under subsection (c), but instead all of the community income other than that described in paragraphs (1), (2), and (3) of subsection (b) is to be treated as the income of the spouse who, for such taxable year, had a greater amount of gross income than the other spouse, determined by adding to the amount of the gross income which is separate income of the spouse under the foreign community property laws, the amount of gross community income which is attributed to that spouse by applying the rules of paragraphs (1), (2), and (3) of subsection (b).

(d) *Time for making elections; period of limitations; etc.*—Subsection (d) of new section 981 contains rules applicable to the making of the elections allowed under subsection (a) and (c) and contains special rules relating to the limitation periods on assessment, credits, and refunds, as well as rules relating to the running of interest on overpayments and deficiencies.

Time

Paragraph (1) of subsection (d) provides that the election under subsection (a) or (c) may be made for a taxable year at any time such taxable year is open, and is to be made in such manner as the Secretary of the Treasury or his delegate prescribes by regulations. In the case of the U.S. citizen spouse, the term "open taxable year" is defined in paragraph (2) of subsection (e).

Extension of period for assessing deficiencies and making refunds

Paragraph (2) of subsection (d) provides in effect that the period for assessing a deficiency against either spouse for any taxable year for which an election under subsection (a) or (c) applies, and the period within which a claim for credit or refund of an overpayment for such taxable year may be filed by either spouse, to the extent that such deficiency or overpayment is attributable to such election, is not to expire before 1 year after the date of such election. This extension of the period of limitations applies to both spouses, since under paragraph (2) of subsection (e), discussed below, each taxable year of the nonresident alien spouse to which an election applies is an open taxable year for purposes of paragraph (2) of subsection (d). The extension of the period of limitations under paragraph (2) of subsection (d) does not apply to taxable years of a nonresident alien spouse who is not required, by reason of paragraph (3) of subsection (d), to join in the election allowed by subsection (c).

Alien spouse need not join in subsection (c) election in certain cases

Paragraph (3) of subsection (d) provides two circumstances under which the nonresident alien spouse referred to in subsection (a) (1) (C) is not required to join with the U.S. citizen spouse in making the election allowed by subsection (c) in order to make such election valid. Pursuant to subsection (d) (3), the nonresident alien spouse is not required to join in the election made under subsection (c) by the U.S. citizen spouse if the Secretary of the Treasury or his delegate determines that (1) the election under subsection (c) would not affect the U.S. income tax liability of the nonresident alien spouse for any taxable year beginning before January 1, 1967, or (2) the effect of the election on the nonresident alien spouse's liability for U.S. income tax for any such taxable year cannot be ascertained and that to deny the election under subsection (c) to the U.S. citizen spouse for open taxable years beginning before January 1, 1967, would be inequitable and cause undue hardship.

Interest

Paragraph (4) of subsection (d) delays the running of interest on a deficiency or overpayment of tax attributable to the making of the election allowed under subsection (a) or (c), so that interest on such a deficiency or overpayment is not to be paid or allowed for any period before the day which is 1 year after the date of such election.

(e) *Definitions and special rules.*—Subsection (e) of new section 981 contains definitions and special rules necessary for the application of the provisions of such section.

Paragraph (1) provides that deductions allowable under the code are to be treated in a manner consistent with the manner provided by section 981 for the income to which such deductions relate.

Paragraph (2) defines the term "open year" as used in section 981. Under this paragraph a taxable year of the U.S. citizen and his spouse is to be treated as "open" if the period for assessing a deficiency against such citizen has not expired before the date of the making of the election allowed by subsection (a) or (c), whichever applies. Thus, if a taxable year of a nonresident alien spouse who has joined in an election either ends or begins within the open taxable year of his

U.S. citizen spouse, such taxable year of the nonresident alien spouse is to be considered "open" for purposes of subsection (d) (2), and the period for assessing a deficiency for such taxable year is not to expire before 1 year after the date of such election. This is true although prior to the filing of such election, the assessment period for the taxable year of the nonresident alien spouse had expired. Paragraph (3) provides that, in those cases where one spouse is deceased and such spouse is required to join in making the election under subsection (a) or (c), as the case may be, the executor, administrator, or other person charged with the property of such decedent may join in making the election. Paragraph (4) provides that if one of the spouses dies, then the taxable year of the surviving spouse is to be treated as closing on the date of such death for the purpose of applying sections 981(a) (1) (C) and 981 (c) (2) to such year.

SECTION 5 OF BILL—CONTINUED

Clerical or conforming amendments

Paragraph (2) of section 5(e) of the bill adds new subpart H to the table of subparts for part III of subchapter N of chapter 1 of the code.

Paragraph (3) of section 5(e) amends section 911(d) of the code (relating to cross-references in respect of earned income from sources without the United States) to include therein a new paragraph containing a cross-reference to new section 981.

SECTION 6 OF BILL. FOREIGN TAX CREDIT

(a) *Allowance of credit to certain nonresident aliens and foreign corporations.*—Paragraph (1) of section 6(a) of the bill amends subpart A of part III of subchapter N of chapter 1 of the code (relating to the foreign tax credit) by adding a new section 906 which allows certain nonresident alien individuals and foreign corporations a credit under section 901 for foreign income taxes. Under present law nonresident alien individuals and foreign corporations are not allowed a foreign tax credit under section 901, except that a nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year is allowed such a credit. The amendment is effective for taxable years beginning after December 31, 1966.

The credit allowed pursuant to section 906 is determined in basically the same manner as the credit would be determined if the nonresident alien individual were a citizen of the United States, or the foreign corporation were a domestic corporation managed and controlled in the United States, and all of the income of such citizen or domestic corporation consisted of the alien's or foreign corporation's income which is effectively connected with the conduct of a trade or business within the United States.

CODE SECTION 906. NONRESIDENT ALIEN INDIVIDUALS AND FOREIGN CORPORATIONS

(a) *Allowance of credit.*—Subsection (a) of new section 906 extends the foreign tax credit allowed under section 901 of the code to nonresident alien individuals and foreign corporations who are en-

gaged in trade or business in the United States at any time during the taxable year and have income for such taxable year which is effectively connected with the conduct of a trade or business within the United States and is subject to tax pursuant to section 871(b) or 882(a), as amended by the bill.

A nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year; that is, an alien to whom section 876 of the code applies, is not allowed a foreign tax credit pursuant to section 906. A citizen of a possession of the United States who is taxable pursuant to section 932(a) of the code, as amended by section 3(m) of the bill, in the same manner as a nonresident alien individual is subject to tax pursuant to section 871(b), as amended by the bill, and is allowed a foreign tax credit pursuant to section 906.

The amount of the credit under section 906 is based on the income, war profits, and excess profits taxes, and taxes included in the term "income, war profits, and excess profits taxes" by reason of section 903 of the code, paid or accrued during the taxable year to a foreign country or possession of the United States on or with respect to income which is effectively connected with the conduct of a trade or business within the United States. The credit is also allowed with respect to such foreign taxes which are deemed paid or accrued during the taxable year under section 902 of the code if the dividends received upon which the section 902 credit is based are effectively connected with the conduct of a trade or business within the United States by the recipient of the dividends.

(b) *Special rules.*—Subsection (b) of section 906 contains special rules concerning the allowance of the foreign tax credit to nonresident alien individuals and foreign corporations pursuant to section 906. It also provides a rule for determining the amount of foreign income taxes for which such persons may claim a deduction in determining the taxable income which, pursuant to amended section 871(b) or 882(a), is subject to the tax imposed by section 1 or 11. This subsection does not apply to a nonresident alien individual to whom section 876 of the code applies.

Foreign taxes for which credit or deduction is not allowed

Paragraph (1) of section 906(b) provides that a credit against tax, or a deduction from gross income under amended section 873(a) or 882(a) (1) (A), is not to be allowed for income, war profits, or excess profits taxes paid or accrued to a foreign country or possession of the United States on income which is effectively connected with the conduct of a trade or business within the United States if the taxes so imposed are imposed solely by reason of the fact that the nonresident alien individual is a citizen or resident of that country or possession or that the foreign corporation is created or organized under the law of that country or possession or has its domicile for tax purposes there.

This provision, in effect, requires that the taxes paid or accrued to a foreign country or possession which taxes the worldwide income of the alien individual or foreign corporation be disregarded for purposes of the foreign tax credit, or of the deduction under section 873(a) or 882(c) (1) (A), if such country or possession would not have taxed such income (1) had the alien individual been a citizen and resident

of another country or (2) had the foreign corporation been created or organized under the law of another country and had its domicile in another country. In applying section 906(b)(1) to any foreign country or possession of the United States the laws of such country or possession are to be used for purposes of determining whether an individual is a resident of, or a corporation is domiciled for tax purposes in, such country or possession.

The amount of the foreign taxes which is to be taken into account for purposes of section 906(a), 873(a), or 882(c)(1)(A) is, if such amount cannot otherwise be specifically allocated to an item or class of income, generally to be that amount which bears the same ratio to the total income taxes payable to the foreign country of residence or domicile as the taxable income which is effectively connected with the conduct of a trade or business within the United States and is taxable by that foreign country for reasons other than the residence of the individual, or the domicile of the foreign corporation, therein bears to the total taxable income of such individual or corporation from all sources.

The application of section 906(b)(1) may be illustrated by the following example:

Example

M, a corporation organized under the law of foreign country Z, is engaged in trade or business within the United States during the taxable year through an office located in the United States. Upon the basis of the facts assumed, M Corporation is allowed to take into account under section 906(b)(1) in determining the credit against tax, or its deductions from income, the following amounts of foreign income taxes:

Gross income (all effectively connected with the conduct of a trade or business within the United States) having the following source under the laws of the United States:	
Sources within United States.....	\$50.00
Sources within country Y.....	50.00
Total gross income.....	100.00
Deductions allowable under the laws of the United States and country Z...	25.00
Country Y tax for purposes of sec. 906(a) or 882(c), assuming a 30-percent rate on gross income from Y sources (\$50 times 30 percent).....	15.00
Country Z tax imposed at a 50-percent rate on \$75 taxable income of M corporation solely because M corporation is created under the law of country Z.....	37.50
Total foreign income taxes taken into account for purposes of the foreign tax credit under sec. 906(a), or for purposes of deductions allowable under sec. 882(c) (country Y tax).....	15.00

Limitation on amount of credit

Paragraph (2) of section 906(b) provides in effect that, in determining under section 904 of the code the maximum foreign tax credit allowable (pursuant to section 906(a)) for any taxable year, (1) the taxable income from sources within a foreign country or possession for purposes of section 904(a)(1) is to be only the taxable income from such sources which is effectively connected with the conduct of a trade or business within the United States, (2) the taxable income from sources without the United States for purposes of section 904(a)(2) is to be only the taxable income from sources without the United States which

is effectively connected with the conduct of a trade or business within the United States, and (3) the entire taxable income for purposes of section 904(a) is to be only the taxpayer's total taxable income which is subject to tax for the taxable year pursuant to section 871(b) or 882(a), as amended by the bill. None of the income for the taxable year which is subject to the tax imposed by section 871(a) or 881, as amended by the bill, is to be taken into account for purposes of applying section 904. In applying the provisions of section 904 to the credit allowable pursuant to section 906, no amount of excess tax paid may be carried from or to any taxable year beginning before January 1, 1967, and no such taxable year is to be taken into account. The application of section 906(b)(2) may be illustrated by the following example:

Example

The facts are the same as those given in the example illustrating the provisions of paragraph (1) of section 906(b). Foreign country Z does not allow a credit against its tax for the amount of the United States income tax. Assuming that M corporation has elected to take a foreign tax credit and apply the overall limitation of section 904(a)(2), the limitation on the amount of the credit allowed pursuant to section 906 for the taxable year is determined as follows:

Gross income for purposes of U.S. tax	\$100.00
Deductions allowable under sec. 882(c)	25.00
Taxable income for purposes of sec. 882(a)	75.00
Taxable income from sources without the United States, pro rata allocation of deductions being assumed (\$75 times \$50/\$100)	37.50
U.S. tax under sec. 882(a) before foreign tax credit (surtax exemption under sec. 11(d) of the code being disregarded for simplification) (\$75 times 48 percent)	36.00
Limitation on foreign tax credit: \$36 times \$37.50/\$75 equals \$18, but not to exceed creditable tax of \$15	15.00
U.S. tax payable	21.00

Tax against which credit may be taken

Paragraph (3) of section 906(b) provides that the credit allowed pursuant to section 906(a) is to be allowed only against the U.S. tax imposed pursuant to amended section 871(b) or 882(a) on the taxable income which is effectively connected with the conduct of a trade or business within the United States. For example, if in the above example under section 906(b)(1), M Corporation had any income from sources within the United States for the taxable year which was not effectively connected with the conduct of a trade or business within the United States and was subject to the tax imposed under amended section 881(a), such tax could not be reduced by the credit allowed pursuant to section 906(a) and such tax (and income) could not be taken into account in determining the limitation provided in section 904(a) on the amount of the foreign tax credit allowable for the taxable year against the tax imposed pursuant to amended section 882(a).

Treatment as a domestic corporation

Paragraph (4) of section 906(b) provides that, for purposes of sections 902(a) and 78 of the code, a foreign corporation receiving dividends described in section 902(a) is to be treated as a domestic

corporation if for the taxable year such corporation chooses the benefits of the foreign tax credit allowable pursuant to section 906(a). Pursuant to the provisions of paragraph (4) the benefits of section 902 with respect to the dividends received are allowed to foreign corporations choosing to take the foreign tax credit under section 901, and the gross-up requirement of section 78 is made applicable with respect to the taxes deemed paid under section 902(a) (1) by reason of such credit. These provisions apply, however, only if the dividends which are described in section 902(a) and received by the foreign corporation which is subject to the tax imposed pursuant to amended section 882(a) are effectively connected with the conduct of a trade or business within the United States by such recipient foreign corporation.

In applying section 902(a) to such foreign corporation owning at least 10 percent of the voting stock of the foreign corporation paying the dividends, the foreign corporation paying the dividends will be deemed under section 902(b) to have paid foreign income taxes by reason of the receipt of any dividends from another foreign corporation 50 percent or more of whose voting stock it owns. It is not necessary to make any determination as to whether the dividends paid by such other foreign corporation are effectively connected with the conduct of a trade or business within the United States.

SECTION 6 OF BILL—CONTINUED

Clerical or conforming amendments

Paragraph (2) of section 6(a) of the bill adds new section 906 to the table of sections for subpart A of part III of subchapter N of chapter 1.

Paragraph (3) of section 6(a) makes a conforming amendment in section 874(c) of the code (relating to the allowance of the foreign tax credit to nonresident alien individuals). Under existing section 874(c) a nonresident alien individual who is not described in section 876 of the code is never allowed the foreign tax credit under section 901.

Paragraph (4) of section 6(a) amends subsection (b) of section 901 of the code (relating to the amount allowed as a credit) by redesignating paragraph (4) as paragraph (5) and by inserting a new paragraph (4) which provides that the amount of the foreign tax credit allowed under section 901(a) in the case of a nonresident alien individual not described in section 876 of the code or of a foreign corporation is to be determined under new section 906. Since a nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year is, by reason of section 876, not subject to the tax imposed pursuant to section 871(b), such alien's foreign tax credit is not determined pursuant to new section 906. The credit against tax allowed in the case of such an alien described in section 876 is the amount allowed under existing section 901(b) (3) of the code.

Paragraph (5) of section 6(a) makes a conforming amendment in paragraph (5) of section 901(b), as so redesignated.

Effective date

Paragraph (6) of section 6(a) provides that the amendments made by section 6(a) are to apply with respect to taxable years beginning after December 31, 1966. This paragraph also provides that, in ap-

plying section 904 with respect to the credit allowed pursuant to section 906, no excess tax may be carried from or to any taxable year beginning before January 1, 1967. Thus, in determining under section 906 foreign income taxes paid or accrued for a taxable year beginning after December 31, 1966, no taxes are to be deemed paid or accrued for such year by reason of a carryover under section 904 (d) or (e) from any taxable year beginning before January 1, 1967. Moreover, if in applying section 906 for any taxable year beginning after December 31, 1966, the foreign income taxes paid or accrued for such year with respect to income effectively connected with the conduct of a trade or business within the United States exceed the applicable limitation under section 904(a) with respect to the tax imposed pursuant to amended section 871(b) or 882(a), none of such excess taxes may be carried back and deemed paid or accrued in any taxable year beginning before January 1, 1967. Computations in respect of a taxable year beginning before January 1, 1967, are in no way to serve to reduce a carryback or a carryover from a taxable year beginning after December 31, 1966, in respect of the foreign income taxes allowable as a credit pursuant to section 906(a).

(b) *Alien residents of the United States or Puerto Rico.*—Subsection (b) of section 6 of the bill provides for the elimination, subject to specified safeguards, of the so-called similar credit requirement in respect of the income tax credit allowed by reason of section 901(b) (3) of the code for certain foreign income taxes and in respect of the estate tax credit allowed by reason of section 2014(a) of the code for certain foreign death taxes.

Under existing section 901(b) (3) an alien individual who is a resident of the United States or who is a bona fide resident of Puerto Rico for the entire taxable year is allowed the credit under section 901 for income, war profits, and excess profits taxes paid or accrued to any foreign country, only if the foreign country of which such alien is a citizen or subject provides a similar credit to citizens of the U.S. resident in the country of which such alien is a citizen or subject.

Under existing section 2014(a) the estate of a decedent who was not a citizen of the United States but was a resident thereof is allowed the credit under section 2014 for estate, inheritance, legacy, or succession taxes paid to any foreign country, only if the foreign country of which such decedent was a citizen or subject provides a similar credit to the estate of a citizen of the United States resident at the time of death in the country of which such alien was a citizen or subject.

Deletion of the similar credit requirement in case of income taxes

Paragraph (1) of section 6(b) of the bill deletes the similar credit requirement now contained in section 901(b) (3) of the code. Paragraph (2) of section 6(b) makes existing subsections (c) and (d) of section 901 subsections (d) and (e) and adds a new subsection (c). New subsection (c) provides that the President may reinstate such similar credit requirement if certain findings are made. The findings required to be made by the President as a prerequisite to the reinstatement of such similar credit requirement are substantially the same as those required as a prerequisite for the reinstatement of pre-1967 income tax law under the authority of section 896, as added by section

5(b) of the bill. These amendments are effective for taxable years beginning after December 31, 1966.

The President is to proclaim the application of the similar credit requirement with respect to resident alien individuals who are citizens or subjects of a particular foreign country if he finds (1) that such foreign country does not allow a similar credit to citizens of the United States resident in such foreign country; (2) that such foreign country, after being requested by the United States, has not acted to provide a similar credit to such citizens of the United States; and (3) that it is in the public interest to allow the credit under section 901(b)(3) to citizens or subjects of such foreign country only on a reciprocal basis. For taxable years beginning while the President's proclamation is in effect, the credit under section 901(b)(3) is to be allowed to citizens or subjects of the foreign country with respect to which the proclamation is issued only if a similar credit is provided by such country to citizens of the United States resident in such country.

Deletion of the similar credit requirement in case of death taxes

Paragraph (3) of section 6(b) of the bill amends section 2014(a) of the code (relating to credit for foreign death taxes) by deleting the similar credit requirement contained therein and by adding a new subsection (h) authorizing the President to reinstate the similar credit requirement under prescribed conditions. The amendment is applicable to estates of decedents dying after the date of the enactment of the bill. The provisions of new subsection (h) are essentially similar to the provisions of new subsection (c) of section 901, as added by paragraph (2) of section 6(b), except that new subsection (h) applies to the Federal estate tax.

Effective dates

Paragraph (4) of section 6(b) provides that the amendments made by subsection (b) of section 6, other than by paragraph (3), apply with respect to taxable years beginning after December 31, 1966. The amendment made by paragraph (3) applies with respect to estates of decedents dying after the date of the enactment of the bill.

(c) *Foreign tax credit in case of certain overseas operations funding subsidiaries.*—Subsection (c) of section 6 of the bill amends section 904(f) of the code (relating to the application of limitations on the foreign tax credit in the case of certain interest income). In general, section 904(f) presently provides that, in determining the limitation on the amount of the foreign tax credit under section 904, interest from foreign sources is to be treated separately from other income from foreign sources and the per-country limitation is to be applied in computing the limitation on the foreign tax credit in the case of such interest. Paragraph (2) of subsection (f), which describes the interest to which subsection (f) applies, excepts from the application of that subsection: (1) Interest derived from any transactions, directly related to the active conduct of a trade or business in a foreign country or U.S. possession; (2) interest derived in the conduct of a banking, financing, or similar business (such as an insurance company business); (3) interest received from a corporation in which the taxpayer owns at least 10 percent of the voting stock; and (4) interest received on obligations acquired as the result of disposition

of a trade or business actively conducted by a taxpayer in a foreign country or as a result of a disposition of stock or obligations of a corporation in which the taxpayer owns at least 10 percent of the voting stock. Paragraph (1) of subsection (c) amends paragraph (2) of section 904(f) by adding a new subparagraph (E) which excepts from the application of section 904(f) interest received by an overseas operations funding subsidiary on obligations of a related foreign corporation.

Definitions necessary for the application of the new subparagraph (E) are contained in a new paragraph (5) of section 904(f), as added by paragraph (2) of subsection (c). Subparagraph (A) of new paragraph (5) defines the term "overseas operations funding subsidiary" to mean a domestic corporation which is a member of an affiliated group of corporations within the meaning of section 1504 of the code (other than the common parent corporation of such affiliated group) and which was formed, and is availed of, for the principal purpose of raising funds outside the United States through public offerings to foreign persons and of using such funds to finance the operations in foreign countries of one or more related foreign corporations. For purposes of applying subparagraph (A), a foreign person is a person who is not a U.S. person within the meaning of section 7701(a) (30) of the code. Funds are not to be considered to be raised in the United States merely because negotiations essential to the raising of such funds have occurred, in whole or in part, in the United States.

In determining for purposes of new subparagraph (E) of section 904(f) (2) whether interest paid to a domestic corporation which is an overseas operations funding subsidiary is paid on obligations of a related foreign corporation and whether such domestic subsidiary corporation's activities meet the principal purpose test of subparagraph (A) of new section 904(f) (5), the term "related foreign corporation", as defined in subparagraph (B) of new section 904(f) (5), means a foreign corporation of which an aggregate of 50 percent or more of the voting stock is owned either directly by members of the affiliated group of which such domestic subsidiary corporation is a member or indirectly by such member corporations through ownership of the voting stock of a single other foreign corporation. Thus, for example, if the members of the affiliated group together own directly 100 percent of the voting stock of foreign corporation N and foreign corporation N in turn owns directly 50 percent or more of the voting stock of foreign corporation M, then foreign corporation M is a related foreign corporation with respect to a domestic corporation which is an overseas operations funding subsidiary and a member of such affiliated group. However, if in turn foreign corporation M owns directly 100 percent of the voting stock of foreign corporation R, foreign corporation R is not a related foreign corporation with respect to such overseas operations funding subsidiary.

Where the members of the affiliated group so own stock in a foreign corporation indirectly through separate other foreign corporations, the aggregate indirect ownership is to be taken into account for determining whether the 50-percent ownership test of subparagraph (B) of new section 904(f) (5) is met.

Paragraph (3) of subsection (c) provides that the amendments made by paragraphs (1) and (2) of subsection (c) are to be effective

with respect to interest received by a domestic corporation after December 31, 1965, in taxable years of such recipient ending after that date.

SECTION 7 OF BILL. AMENDMENT TO PRESERVE EXISTING LAW ON DEDUCTIONS UNDER SECTION 931

(a) *Deductions.*—Subsection (a) of section 7 of the bill amends section 931(d) of the code (relating to deductions available to U.S. citizens and domestic corporations entitled to the benefits of sec. 931) in order to preserve existing law for determining the taxable income of such persons. Section 931(d), as so amended, adopts the provisions of subsections (a), (b), (c), and (e) of existing section 873 of the code and paragraphs (2) and (3) of existing section 882(c) of the code, except that under amended section 931(d) (2) (c) the individual is allowed a deduction for contributions or gifts to or for a trust described in section 170(c) (2). This is consistent with the change made in paragraph (2) of section 873(b), as amended by section 3(c) of the bill.

(b) *Effective date.*—Subsection (b) of section 7 of the bill provides that the amendment made by section (a) applies with respect to taxable years beginning after December 31, 1966.

SECTION 8 OF THE BILL. ESTATES OF NONRESIDENTS NOT CITIZENS

(a) *Rate of tax.*—Subsection (a) of section 8 of the bill strikes out subsection (a) of section 2101 of the code (relating to tax imposed in case of estates of nonresidents not citizens) and substitutes in its place a new subsection (a).

Under present subsection (a) of section 2101, the taxable estate of a nonresident not a citizen of the United States is subject to the tax computed in accordance with the table of rates contained in section 2001, which is the tax table used in computing the tax on estates of citizens or residents of the United States. These rates begin at 3 percent on the first \$5,000 of a taxable estate and reach a maximum of 77 percent on that part of a taxable estate in excess of \$10 million.

New subsection (a) of section 2101 contains a separate tax table of lower rates, ranging from 5 percent on the first \$100,000 of a taxable estate to a maximum rate of 25 percent on that part of a taxable estate in excess of \$2 million.

The new subsection applies to estates of nonresidents not citizens, including certain citizens of the United States who were residents of a possession of the United States and who are considered nonresidents not citizens under section 2209 of the code, who die after the date of enactment of the bill.

(b) *Credits against tax.*—Subsection (b) of section 8 of the bill amends section 2102 of the code (relating to credits allowed against estate tax). This amended section retains existing law in subsection (a), which provides that the estate tax imposed on the estate of a nonresident not a citizen of the United States is to be reduced by the credits prescribed in sections 2011 to 2013, inclusive, relating to State death taxes, gift tax, and estate tax on prior transfers, respectively.

New subsection (b) of section 2102 provides a special limitation on the allowance of the credit provided by section 2011, relating to State death taxes. Under this special limitation, the maximum credit allowable for State death taxes is the amount which bears the same ratio to the maximum credit computed as provided in section 2011(b) as the value of the property (determined at the date of death or as provided in sec. 2032 of the code) upon which a State death tax was actually paid and which is included in the gross estate under section 2103 bears to the value of the total gross estate under section 2103.

(c) *Property within the United States.*—Subsection (c) of section 8 of the bill amends section 2104 of the code (relating to property within the United States) by adding at the end thereof a new subsection (c) (relating to debt obligations).

Section 2103 provides that the value of the gross estate of every decedent nonresident not a citizen of the United States consists only of the value of that portion of the property otherwise includible in his gross estate which at the time of his death is situated in the United States. In the regulations under existing section 2104 of the code a debt obligation the written evidence of which is treated as being the property itself (e.g., a bond) is considered to be situated in the United States only if the written evidence is located within the United States. Under existing section 2105(b) of the code deposits in the United States with any person carrying on the banking business are considered situated within the United States only if the decedent was engaged in business in the United States at the time of his death. Any other debt obligation the written evidence of which is not treated as the property itself is considered, in the regulations under section 2104, to be situated within the United States if issued by or enforceable against a resident of the United States or a domestic corporation or governmental unit.

New subsection (c) of section 2104 provides that, with one exception, a debt obligation owned by a nonresident not a citizen of the United States is to be considered property within the United States, and thus includible in the gross estate of such a decedent, if the primary obligor with respect to such debt obligation is any of the following:

(1) A U.S. person (as defined in sec. 7701(a)(30)), or

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

This rule applies whether or not the written evidence of the debt obligation is treated as being the property itself. Except as provided in section 2105(b) (relating to deposits with a foreign branch of a domestic corporation), as amended by section 8(d) of the bill, this rule also applies in the case of bank deposits. Currency is not a debt obligation for purposes of subsection (c). The one exception to the rule is that a debt obligation of a domestic corporation is not to be treated as property within the United States when owned by a nonresident not a citizen in a case where any interest on such obligation, if it were received by the decedent at the time of his death, would be treated by reason of the application of section 861(a)(1)(B) of the code as income from sources without the United States.

This exception applies whether or not interest is in fact paid on the obligation. Debt obligations of obligors not described in section 2104(c) (1) and (2), as added by this subsection, are not to be deemed

property within the United States even though there is located in the United States the written evidence of such obligation which is treated as being the property itself.

(d) *Property without the United States.*—Subsection (b) of section 2105 presently provides that, in the case of estates of non-residents not citizens of the United States who were not engaged in business in the United States at the time of death, any moneys deposited by or for such decedents with any person carrying on the banking business shall be considered to be property outside the United States (and thus not includible in the gross estates of such decedents).

Subsection (d) of section 8 of the bill deletes subsection (b) of section 2105 and inserts a new subsection (b) which provides that deposits with a foreign branch of a domestic corporation shall be considered to be property outside the United States if such branch is engaged in the commercial banking business. The new provision applies whether or not the decedent was engaged in business in the United States at the time of his death, and whether or not the deposits, upon withdrawal, are payable in U.S. dollars.

Any bank deposit made by or for a nonresident not a citizen of the United States with a U.S. person, other than a deposit to which new subsection (b) of section 2105 applies, is considered under new subsection (c) of section 2104 to be property within the United States, if such deposit is not a debt obligation to which the last sentence of subsection (c) of section 2104 applies.

(e) *Definition of taxable estate.*—Subsection (e) of section 8 of the bill amends paragraph (3) of section 2106(a) of the code (relating to the deduction of an exemption from the gross estate of nonresidents not citizens of the United States).

Subparagraph (A) of this amended paragraph raises the exemption allowed in respect of the estate of a nonresident not a citizen of the United States from the existing \$2,000 to \$30,000. Subparagraph (B) provides that, in the case of decedents who were citizens of the United States and residents of a possession of the United States at the time of death but who are considered nonresidents not citizens of the United States by reason of section 2209, the exemption is to be the greater of either \$30,000 or that proportion of the exemption (now \$60,000) authorized by section 2052 (relating to the exemption allowed in respect of estates of decedent citizens or residents of the United States) 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.

If under an applicable estate tax convention to which the United States is a party the estate tax exemption in the case of a nonresident decedent not a citizen of the United States is in excess of \$30,000, such treaty exemption is to apply for purpose of determining the tax imposed by section 2101, as amended by section 8(a) of the bill, or by section 2107, as added by section 8(f) of the bill.

(f) *Special methods of computing tax.*—Subsection (f) of section 8 of the bill amends subchapter B of chapter 11 of the code (relating to estates of nonresidents not citizens) by adding new sections 2107 (relating to expatriation to avoid tax) and 2108 (relating to application of pre-1967 estate tax provisions). These new sections apply

with respect to estates of decedents dying after the date of the enactment of the bill.

CODE SECTION 2107. EXPATRIATION TO AVOID TAX

(a) *Rate of tax.*—New section 2107 provides a special tax computation for the estates of decedent nonresidents not citizens of the United States, who lost U.S. citizenship after March 8, 1965, and within 10 years of death, and who had as a principal purpose for such loss the avoidance of U.S. income, estate, or gift tax. Subsection (a) of such section provides that the taxable estate of such a decedent shall be subject to tax at the rates set out in section 2001, which are the rates used in the case of estates of U.S. citizens or residents. For this purpose, the taxable estate is determined as provided in section 2106 in the same manner as that provided for in the case of any other decedent nonresident not a citizen of the United States, except that in determining such taxable estate the gross estate of such a decedent also includes, under subsection (b) of section 2107, a proportion of the fair market value of any stock owned by the decedent in a foreign corporation, if the corporation was controlled by the decedent and had assets situated in the United States.

(b) *Gross estate.*—Subsection (b) of section 2107 provides that as a general rule the gross estate of a decedent to whom subsection (a) of section 2107 applies is determined as provided in section 2103 with respect to the estate of any other decedent nonresident not a citizen of the United States. Subsection (b) also provides an exception to this general rule which is designed to prevent a decedent to whom subsection (a) of section 2107 applies from avoiding Federal estate tax by transferring to a foreign corporation under his control property which would otherwise be includible in his gross estate for Federal estate tax purposes if such property had not been transferred to such corporation. For purposes of the application of this exception, such a decedent is considered to have been in control of a foreign corporation at the time of his death if the tests set out in paragraphs (1) and (2) of subsection (b) are both met.

The test contained in paragraph (1) is that the decedent must have owned, at the time of his death, either directly or indirectly (within the meaning of sec. 958(a) of the code and the regulations thereunder) through certain foreign entities, at least 10 percent of the total combined voting power of all classes of stock entitled to vote of the foreign corporation.

The test contained in paragraph (2) is that the total of the stock which the decedent owned, either directly or indirectly as described in paragraph (1), and the stock which he was considered to have owned by applying any applicable constructive ownership rules of section 958(b), at the time of his death, must have constituted more than 50 percent of the total combined voting power of all classes of stock entitled to vote of the foreign corporation. For purposes of this subsection (b) the decedent is 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 section 2035, 2036, 2037, or 2038 of the code, he owned such stock. The same shares of stock may not be counted more than once in determining whether or not the 50-percent

test contained in paragraph (2) is met, even though the decedent both is treated as having owned the shares (within the meaning of this subsection without reference to sec. 958(b)) and is considered to have owned the shares by applying the constructive ownership rules of section 958(b); as, for example, in a case where the decedent had given the shares to his wife in contemplation of death.

If the ownership tests of paragraphs (1) and (2) of subsection (b) are both met, the gross estate of the decedent is to include, in addition to items includible therein under section 2103 of the code, that proportion of the fair market value of the stock of the foreign corporation owned by the decedent, at the time of his death, which the fair market value of any assets owned by the foreign corporation and situated in the United States at the time of his death bears to the fair market value of all of the corporation's assets, wherever situated, at such time. The fair market value of assets, wherever situated, of the foreign corporation shall be determined without reduction for any outstanding liabilities of such corporation. The alternate valuation date provided by section 2032 of the code may be used in determining the value of the gross estate under subsection (b) of section 2107, but the ownership tests of paragraphs (1) and (2) of such subsection must be determined solely by reference to the time of death.

The application of the provisions of subsection (b) of section 2107 is illustrated by the following example.

Example.—H, a nonresident decedent to whom section 2107 applies, owned stock worth \$50,000 which constituted 40 percent of the total combined voting power of all classes of stock entitled to vote of foreign corporation M. W, his wife, owned stock constituting 20 percent of the combined voting power. H transferred all of his stock in M corporation to W in contemplation of death within the meaning of section 2035. At the time of H's death, 30 percent of the fair market value of the assets of the corporation were situated within the United States. The test of paragraph (1) is met since H "owned" (within the meaning of that paragraph) 40 percent of the combined voting power at the time of his death, and the test of paragraph (2) is met since, under that paragraph, H is treated as having owned 60 percent of the combined voting power (having constructive ownership of his wife's 20 percent of combined voting power, in addition to his own 40 percent of such power) at the time of his death. Accordingly, an amount equal to 30 percent (the percentage of the fair market value of the corporation's assets which were situated within the United States at H's death) of \$50,000 (the fair market value of the stock "owned" by H), or \$15,000, is included in H's gross estate.

(c) *Credits.*—Subsection (c) of section 2107 provides that in computing the Federal estate tax on the transfer of the taxable estate of a decedent nonresident not a citizen of the United States which is subject to tax under the provisions of subsection (a), credits against the tax are to be allowed in accordance with the provisions of section 2102, as amended by section 8(b) of the bill, for State death taxes, gift tax, and estate tax on prior transfers. In applying section 2102(b) for this purpose the gross estate is to be determined in the manner provided by subsection (b) of section 2107.

(d) *Exception for loss of citizenship for certain causes.*—Subsection (d) of section 2107 provides that the provisions of subsection (a) of

such section are not to apply to the transfer of the estate of a decedent whose loss of U.S. citizenship resulted from the application of section 301(b), 350, or 355 of the Immigration and Nationality Act, as amended. These sections are discussed in connection with section 877(d), as added by section 3(e) of the bill.

(e) *Burden of proof.*—Subsection (e) of section 2107 provides that, in determining whether a principal purpose for the loss of United States citizenship by an expatriate was the avoidance of U.S. income, estate, or gift taxes, the Secretary of the Treasury or his delegate must first establish that it is reasonable to believe that the decedent's loss of U.S. citizenship would, but for section 2107, substantially reduce his combined Federal and foreign death taxes (including death taxes imposed by political subdivisions of foreign countries). In the absence of complete factual information, the Secretary or his delegate may make a determination, based on the information available, that the decedent's loss of U.S. citizenship would, but for section 2107, substantially reduce his combined Federal and foreign death taxes. Such tentative determination is to be sufficient to establish that it is reasonable to so believe, in the absence of a showing by the executor of the decedent's estate of the actual reduction in such taxes resulting from the decedent's loss of U.S. citizenship.

Such tentative determination may be based upon the fact that the laws of the country of which the decedent became a citizen and the laws of the country of which the decedent was a resident (including the laws of the political subdivisions of such countries) would ordinarily result, in the case of an estate of a person of the decedent's citizenship and residence, in liability for death taxes substantially lower than the amount of tax imposed by subchapter A of chapter 11 of the code on estates of citizens of the United States.

Once the Secretary of the Treasury or his delegate has established that it is reasonable to believe that the decedent's loss of U.S. citizenship would, but for section 2107, substantially reduce his combined Federal and foreign death taxes, the executor of the decedent's estate must show that such loss did not have for one of its principal purposes the avoidance of U.S. income, estate, or gift taxes.

SECTION 8 OF BILL—CONTINUED

CODE SECTION 2108. APPLICATION OF PRE-1967 ESTATE TAX PROVISIONS

(a) *Imposition of more burdensome tax by foreign country.*—Subsection (a) of section 2108 provides that whenever the President finds that (1) the tax system of any foreign country (including the tax systems of its political subdivisions) imposes a more burdensome tax on the transfer of estates of decedents who were United States citizens not residents of that country than the tax imposed by subchapter B of chapter 11 of the code, as amended (exclusive of this section), on the transfer of estates of decedents who were residents of such foreign country; (2) that such country has not revised or reduced its tax, when requested by the United States to do so, to make it no more burdensome than such U.S. tax; and (3) that it is in the public interest to apply pre-1967 estate tax provisions to estates of residents of such country who were not citizens or residents of the United

States; then the President is to proclaim that the tax on estates of such residents of such foreign country who die after the date of such proclamation is to be determined under subchapter B of chapter 11 without regard to amendments made to sections 2101, 2102, 2106, and 6018 on or after the date of enactment of the bill.

(b) *Alleviation of more burdensome tax.*—Subsection (b) of section 2108 provides that, 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 subchapter B of chapter 11, he is to proclaim that the tax on the transfer of the estates of residents of such foreign country (not citizens of the United States) dying after the date of such proclamation of revocation is to be determined under subchapter B without regard to subsection (a) of section 2108.

(c) *Notification of Congress required.*—Subsection (c) of section 2108 provides that neither the proclamation authorized by subsection (a) nor that authorized by subsection (b) is to be issued unless, at least 30 days prior to such proclamation, the President has notified Congress of his intention to make such proclamation.

(d) *Implementation by regulations.*—Subsection (d) of section 2108 provides that the Secretary of the Treasury or his delegate is to prescribe such regulations as may be necessary or appropriate to implement section 2108.

SECTION 8 OF BILL—CONTINUED

(g) *Estate tax returns.*—Subsection (g) of section 8 of the bill conforms paragraph (2) of section 6018(a) of the code (relating to estate tax returns of estates of nonresidents not citizens) to the amendment made by subsection (e) of section 8 of the bill by striking out “\$2,000” and inserting in lieu thereof “\$30,000”. The effect of amended paragraph (2) is to require an estate tax return in the case of a nonresident not a citizen of the United States only if that part of his gross estate which is situated in the United States exceeds \$30,000.

(h) *Clerical amendment.*—Subsection (h) of section 8 of the bill amends the table of sections for subchapter B of chapter 11 of the code to include new sections 2107 and 2108 of the code, as added by section 8(f) of the bill.

(i) *Effective date.*—Subsection (i) of section 8 of the bill provides that the amendments made by such section is to apply with respect to estates of decedents dying after the date of the enactment of the bill.

SECTION 9 OF BILL. GIFT TAX OF NONRESIDENTS NOT CITIZENS

(a) *Imposition of tax.*—Subsection (a) of section 9 of the bill strikes out subsection (a) of section 2501 of the code and inserts in its place a new subsection (a). Existing subsection (a) of section 2501 of the code provides that a tax, computed as provided in section 2502, is imposed on the transfer of property by gift by any individual, whether resident or nonresident, except transfers of intangible property by a

nonresident not a citizen of the United States who was not engaged in business in the United States during the calendar year of the gift.

Paragraph (1) of new section 2501(a) provides that a tax, computed as provided in section 2502, shall be imposed on the transfer of property by gift by any individual, whether resident or nonresident.

Paragraph (2) contains an exception to paragraph (1) by providing that no gift tax shall be imposed on the transfer of intangible property by gift by any nonresident not a citizen of the United States. This exception applies whether or not the nonresident is engaged in business in the United States during the calendar year and even though the property is situated in the United States.

Paragraph (3) withdraws the exception contained in paragraph (2) in the case of gifts by an expatriate who lost U.S. citizenship (other than as a result of the application of sec. 301(b), 350, or 355 of the Immigration and Nationality Act) after March 8, 1965, and within the 10-year period ending with the date of transfer if such loss of U.S. citizenship had for one of its principal purposes the avoidance of U.S. income, estate, or gift tax. Accordingly, in the case of such an expatriate, the tax provided in section 2502 is imposed on the transfer of intangible property by gift (subject to the limitation with respect to situs contained in sec. 2511(a) of the code). The tax will be imposed in such case irrespective of whether the donor is engaged in business in the United States during the calendar year. Sections 301(b), 350, and 355 of the Immigration and Nationality Act are discussed in connection with section 877(d), as added by section 3(e) of the bill.

Paragraph (4) provides that, in determining whether a principal purpose for the loss of U.S. citizenship by an expatriate donor was the avoidance of U.S. income, estate, or gift tax, the Secretary of the Treasury or his delegate must first establish that it is reasonable to believe that the donor's loss of U.S. citizenship would, but for paragraph (3) of this subsection, result in a substantial reduction in his combined Federal and foreign gift taxes for the calendar year.

In the absence of complete factual information, the Secretary or his delegate may make a tentative determination, based on the information available, that the decedent's loss of U.S. citizenship would, but for paragraph (3) of this subsection, substantially reduce his combined Federal and foreign gift taxes for the calendar year. Such tentative determination shall be sufficient to establish that it is reasonable to so believe, in the absence of a showing by the donor of the actual reduction in such taxes resulting from his loss of U.S. citizenship.

Such tentative determination may be based upon the fact that the laws of the country of which the donor became a citizen and the laws of the country of which the donor is a resident would ordinarily result, in the case of gifts by a person of the donor's citizenship and residence, in liability for gift taxes substantially lower than the amount of tax imposed by chapter 12 of the code on gifts by citizens of the United States.

Once the Secretary or his delegate has established that it is reasonable to believe that the donor's loss of U.S. citizenship would, but for paragraph (3) of this subsection, result in a substantial reduction in his combined Federal and foreign gift taxes for the calendar year, such expatriate donor must show that avoidance of U.S. income, estate, or gift tax was not a principal purpose of his loss of citizenship.

(b) *Transfers in general.*—Subsection (b) of section 9 of the bill amends subsection (b) of section 2511 of the code, relating to the situs rule for stock in a corporation, to provide situs rules for stock in a corporation and debt obligations. Since, under new section 2501 (a) (2), transfers of intangible property by nonresidents not citizens of the United States are no longer subject to the gift tax unless the donor is an expatriate to whom new section 2501 (a) (3) applies, these situs rules apply only to transfers by such expatriates. They are, in general, the same as the situs rules provided for estate tax purposes by section 2104, as amended by section 8(c) of the bill, except that there is in new section 2511 (b) no exception similar to that contained in new section 2104 (c) with respect to debt obligations of a domestic corporation the interest on which would be treated as income from sources without the United States by reason of section 861 (a) (1) (B) of the code. Moreover, no exception is provided in section 2511 of the code comparable to that contained in section 2105 (b), as amended by section 8 (d) of the bill, with respect to deposits in certain foreign branches of domestic corporations.

Accordingly, for gift tax purposes in the case of such expatriates, bank deposits with a domestic corporation are considered debt obligations situated within the United States even though deposited with a foreign branch of the domestic corporation. Shares of stock issued by a foreign corporation and debt obligations of persons not described in new section 2511 (b) (2) shall in no case be considered to be property situated in the United States for purposes of determining the gift tax of such expatriates.

(c) *Effective date.*—The amendments made by section 9 of the bill apply with respect to the calendar year 1967 and all calendar years thereafter.

SECTION 10 OF BILL. TREATY OBLIGATIONS

Section 10 of the bill provides that, if the application of any provision of the bill would be contrary to a treaty obligation of the United States in force on the date of enactment of the bill, the treaty obligation is to prevail. For example, if an income tax convention to which the United States is a party provides that the United States will tax individual residents or corporations of the other country only on income from sources within the United States, then, in the case of such residents or corporations who are entitled to the benefit so accorded by that convention, the provisions of section 871 (b), as amended by section 3 (a) of the bill, and of section 882, as amended by section 4 (b) of the bill, is to apply only to that income effectively connected with the conduct of a trade or business within the United States which is from sources within the United States.

In such case the income from sources without the United States, which in the absence of the convention would be taxable, is to be excluded from gross income by reason of the treaty obligation and the provisions of section 894 (a), as amended by section 5 (a) of the bill.

Section 10 also makes clear that, for such purposes, the extension of any benefit provided by any amendment made by the bill is not to be considered as being contrary to any treaty obligation of the United States. Thus, for example, the benefit accorded by section 894 (b), as

added by section 5(a) of the bill, is to apply notwithstanding the first sentence of section 10 of the bill and notwithstanding the provisions of section 7852(d) of the code (relating to treaty obligations).

VI. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3 of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in *italic*, existing law in which no change is proposed is shown in roman) :

INTERNAL REVENUE CODE OF 1954

Subtitle A—Income Taxes

CHAPTER 1—NORMAL TAXES AND SURTAXES

Subchapter A—Determination of Tax Liability

PART I—TAX ON INDIVIDUALS

SEC. 1. TAX IMPOSED.

(a) RATES OF TAX ON INDIVIDUALS.—

(d) *NONRESIDENT ALIENS.*—*In the case of a nonresident alien individual, the tax imposed by subsection (a) shall apply as provided by section 871 or 877.*

[(d)] (e) CROSS REFERENCE.—

For definition of taxable income, see section 63.

PART II—TAX ON CORPORATIONS

Sec. 11. Tax imposed.

Sec. 12. Cross references relating to tax on corporations.

SEC. 11. TAX IMPOSED.

(a) CORPORATIONS IN GENERAL.—A tax is hereby imposed for each taxable year on the taxable income of every corporation. The tax shall consist of a normal tax computed under subsection (b) and a surtax computed under subsection (c).

(b) NORMAL TAX.—The normal tax is equal to the following percentage of the taxable income:

(1) 30 percent, in the case of a taxable year beginning before January 1, 1964, and

(2) 22 percent, in the case of a taxable year beginning after December 31, 1963.

(c) **SURTAX.**—The surtax is equal to the following percentage of the amount by which the taxable income exceeds the surtax exemption for the taxable year:

(1) 22 percent, in the case of a taxable year beginning before January 1, 1964.

(2) 28 percent, in the case of a taxable year beginning after December 31, 1963, and before January 1, 1965, and

(3) 26 percent, in the case of a taxable year beginning after December 31, 1964.

(d) **SURTAX EXEMPTION.**—For purposes of this subtitle, the surtax exemption for any taxable year is \$25,000, except that, with respect to a corporation to which section 1561 (relating to surtax exemptions in case of certain controlled corporations) applies for the taxable year, the surtax exemption for the taxable year is the amount determined under such section.

(e) **EXCEPTIONS.**—Subsection (a) shall not apply to a corporation subject to a tax imposed by—

(1) section 594 (relating to mutual savings banks conducting life insurance business),

(2) subchapter L (sec. 801 and following, relating to insurance companies), *or*

(3) subchapter M (sec. 851 and following, relating to regulated investment companies and real estate investment trusts) **[, or].**

[(4) section 881(a) (relating to foreign corporations not engaged in business in United States).]

(f) **FOREIGN CORPORATIONS.**—*In the case of a foreign corporation, the tax imposed by subsection (a) shall apply only as provided by section 882.*

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Subchapter B—Computation of Taxable Income

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PART III—ITEMS SPECIFICALLY EXCLUDED FROM GROSS INCOME

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SEC. 116. PARTIAL EXCLUSION OF DIVIDENDS RECEIVED BY INDIVIDUALS.

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(a) **EXCLUSION FROM GROSS INCOME.**—Effective with respect to any taxable year ending after July 31, 1954, gross income does not include amounts received by an individual as dividends from domestic corporations, to the extent that the dividends do not exceed \$100. If the dividends received in a taxable year exceed \$100, the exclusion provided by the preceding sentence shall apply to the dividends first received in such year.

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(d) **CERTAIN NONRESIDENT ALIENS INELIGIBLE FOR EXCLUSION.**—**[**Subsection (a) does not apply to a nonresident alien individual with respect to whom a tax is imposed for the taxable year under section

871(a)] *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).*

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SEC. 154. CROSS REFERENCES.

(1) For definitions of "husband" and "wife", as used in section 152 (b)(4), see section 7701(a)(17).

(2) For deductions of estates and trusts, in lieu of the exemptions under section 151, see section 642(b).

(3) For exemptions of nonresident aliens, see section [873(d)] 873(b)(3).

(4) For exemptions of citizens deriving income mainly from sources within possessions of the United States, see section 931(e).

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PART VIII—SPECIAL DEDUCTIONS FOR CORPORATIONS

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SEC. 245. DIVIDENDS RECEIVED FROM CERTAIN FOREIGN CORPORATIONS.

(a) **GENERAL RULE.**—In the case of dividends received from a foreign corporation (other than a foreign personal holding company) which is subject to taxation under this chapter, if, for an uninterrupted period of not less than 36 months ending with the close of such foreign corporation's taxable year in which such dividends are paid (or, if the corporation has not been in existence for 36 months at the close of such taxable year, for the period the foreign corporation has been in existence as of the close of such taxable year) such foreign corporation has been engaged in trade or business within the United States [and has derived 50 percent or more of its gross income from sources within the United States,] *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*, there shall be allowed as a deduction in the case of a corporation—

(1) An amount equal to the percent (specified in section 243 for the taxable year) of the dividends received out of its earnings and profits specified in paragraph (2) of the first sentence of section 316(a), but such amount shall not exceed an amount which bears the same ratio to such percent of such dividends received out of such earnings and profits as the gross income of such foreign corporation for the taxable year [from sources within the United States] *which is effectively connected with the conduct of a trade or business within the United States* bears to its gross income from all sources for such taxable year, and

(2) An amount equal to the percent (specified in section 243 for the taxable year) of the dividends received out of that part of its earnings and profits specified in paragraph (1) of the first sentence of section 316(a) accumulated after the beginning of