

U.S. source income and therefore subject to U.S. tax if 20 percent or more of the income of the foreign corporation paying the interest is from U.S. sources during the preceding 3-year period.

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. However, in the case of this type of interest income there is no apportionment provision and therefore all of the interest paid by a foreign corporation meeting the 20 percent rule is treated as being from U.S. sources notwithstanding the proportion of the corporation's income which is from U.S. sources.

*Reasons for the provision.*—Your committee agrees with the House that the application of the dividend rule described above should be restricted. In addition, your committee believes that a corresponding restriction should also be applied in the case of interest income since the investment nature of both interest and dividend income is similar. Moreover, your committee was of the opinion that the amount of interest subjected to U.S. tax (as U.S. source income) should be in proportion to the amount of the corporation's income which is effectively connected to its conduct of a trade or business in the United States. In the past, these provisions have given rise to little revenue. On the other hand, the elimination of these provisions 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 these provisions by modifying the applicable rules.

The House bill, in the case of dividends, raised the 50-percent requirement to 80 percent. Your committee has set both the dividend and interest percentage requirement at 50 percent. It is believed that this percentage when combined with the effectively connected limitation gives assurance that this second tax on investment income of foreign corporations will only be imposed where U.S. operations account for the major portion of the income being paid out. The limitation to income which is effectively 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.

*Explanation of provision.*—To achieve the objective set forth above your committee's bill amends the source rule with respect to dividends and interest paid by corporations to provide that no portion of the dividend or interest received from a foreign corporation is to be considered to be from U.S. sources unless 50 percent or more of the corporation's gross income for the 3-year period preceding the year in which the dividends or interest is paid, was effectively connected with the conduct of a trade or business in the United States. Also, the portion of the dividend or interest treated as being from U.S. sources