

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 rate 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 income) of foreign corporations which is 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.

*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.

(A) *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 and the House bill, is taxable at a flat 30-percent rate (or lower treaty rate). Under your committee's bill, 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) contingent income received from the sale of patents and other intangibles, 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. A corresponding amendment to the House bill deleting the tax on income realized with respect to stock of a collapsible corporation was made in this provision. 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 for the 3-year period preceding the year of redemption 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. Moreover, the language in the nonresident alien section of this report clarifying the scope of the references in the bill to section 1232 is equally applicable with respect to this provision.