

I. EXPLANATION OF PROVISIONS

A. FOREIGN INVESTORS TAX ACT

1. INCOME TAX SOURCE RULES

a. Rules for determining source of certain interest payments (sec. 102(a)(1) of the act and secs. 861 (a) and (c) of the code)

Prior law.—Prior law provided that interest on deposits paid to foreign persons not engaged in trade or business in the United States was to be treated as income from sources without the United States and therefore not subject to U.S. tax if the interest was paid by a U.S. bank. The Internal Revenue Service interpreted this rule to apply, in addition to banks, to certain deposits with some types of State-chartered savings and loan associations. However, the Service did not interpret 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 was not accorded the benefits of this special rule.

Explanation of provision.—The act amends prior law to provide that after December 31, 1972, 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 and therefore subject to U.S. tax. A provision was also added which subjects interest on deposits with U.S. branch banks of foreign corporations to these provisions. Therefore, until 1973 only bank interest received by nonresident aliens or foreign corporations 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 6-year period the act extends the application of the foreign source rule of prior 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 (determined without regard to section 265) 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 6-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.

Effective date.—Except for the provision repealing the special foreign source rule for certain interest as of December 31, 1972, these

¹ The term "effectively connected" is explained subsequently in No. 2(b) below.