

ign corporations as a dividend, to the extent the post-1962 earnings and profits of the corporation were attributable to the shares being sold or exchanged. In determining the earnings and profits to be taken into account in determining this gain, prior law excluded 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.

Explanation of provision.—This amendment provides that for taxable years beginning on or after January 1, 1967, the earnings and profits of the foreign corporation (for purposes of sec. 1248) are 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 of tax, pursuant to a treaty.

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

5. MISCELLANEOUS INCOME TAX PROVISIONS, ETC.

a. Income affected by treaty (sec. 105(a) of the act and sec. 894 of the code)

Prior law.—Existing income tax treaties generally provide that the exemptions from tax, or the reduction in rates of tax, provided for in their 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 purpose similar to 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.

Explanation of provision.—Under the tax treatment provided for such persons by the act, the "engaged in trade or business in the United States" criterion 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. The act 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 they have a permanent establishment in the United States, are denied the benefits of treaty rates or exemptions.

The act 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 with a trade or business, a nonresident alien or foreign cor-