Folder Title:	US Bond Issues - Taxes - 1964 to 1975
Folder ID:	1850945
Series:	Subject Files
Dates:	01/01/1964 - 12/31/1975
Fonds:	Personal Papers of Lester Nurick
ISAD Reference Code:	WB IBRD/IDA NURICK-5864S
Digitized:	10/15/2021

U.S.
Bond
Issues

TAXES

L.Nurick

1. Press Release dated November 25, 1947 and copy of letter from the U.S. Treasury of November 19, 1947 re Interest on bonds of the Bank paid to non-resident aliens, or to foreign corporations not engaged in trade or business in the United States, is not subject to Federal income tax under sections 211(a) and 231(a) of the Internal Revenue Code.

2. Press Release dated August 5, 1948 and copy of letter from the U.S. Treasury dated July 21, 1948 re Interest on the bonds of the Bank paid to foreign corporations engaged in trade or business in the United States (other than interest paid to a foreign life insurance company and attributable, under Section 201 of the Internal Revenue Code, to its life insurance business in the United States) is not subject to taxation under the Internal Revenue Code.

3. Note: U.S. Taxes, June 1966

4. Tax Status, from the prospectus for the 25-year Bonds of 1967, due April 1, 1992.

5. The Effectively Connected Concept in the Foreign Investors Tax Act of 1966 by James Sitrick.

6. Memorandum to files re Effect of Foreign Investors Tax Act on Holders of Bank Bonds, dated March 22, 1967.

7. Memorandum to files re Taxability of Bank Bonds (April 4, 1967).

8. Draft memorandum to files (Mr. Clyde) re Bonds: Foreign Investors Tax Act: Foreign Corporations Maintaining Offices in the United States (May 13, 1968).

9. Memorandum dated May 7, 1969 from C.H. Gustafson to Mr. Guttentag re IBRD - U.S. Withholding on IBRD Bond Interest.

10. Memorandum dated April 5, 1971 from J.H. Guttentag to Files re Taxability of Interest Paid by the IBRD to Non-resident Aliens and Foreign Corporations.

11. Letter dated April 9, 1971 from the IRS to Cleary, Gottlieb, Steen & Hamilton, New York, re Asian Development Bank.

12. Memorandum to files dated April 13, 1971 re Asian Development Bank; Tax Ruling Affair.

13. Memorandum dated June 22, 1973 from J.H. Guttentag to Mr. Nurick re Ruling Requests with respect to United States Taxation of IBRD Bonds and Interest thereon (4 attachments).

14. Letter dated January 10, 1974 from A. Broches to the Secretary of the Treasury re request to update rulings (draft ruling attached).

15. Memorandum dated June 28, 1974 from J.H. Guttentag to files re IBRD - IDB - IRS Ruling concerning taxation of bond interest and bonds.

16. Letter dated July 31, 1974 from J.H. Guttentag to Mr. Nurick re status of IBRD request for rulings.

17. Letter dated November 20, 1974 from the IRS to the Bank containing rulings as to the Federal income tax status of the Bank as requested on January 10, 1974 (see No.14).

18. Letter dated Nov. 21, 1974 from Mr. Guttentag to Mr. Nurick in connection with the IRS rulings.

19. Letter dated Dec. 23, 1974 from Mr. Guttentag to Mr. Scott enclosing copy of the ruling issued to the Interamerican Development Bank with respect to its bonds.

20. Letter dated Dec. 27, 1974 from Mr. Guttentag to Mr. Scott enclosing a marked-up copy of the Salomon Brothers Memorandum re the foreign tax credit.

21. Letter dated Dec. 30, 1974 from Mr. Guttentag to Mr. Nurick re IRS rulings.

22. Memorandum dated Jan. 3, 1975 from Piero Sella to Mr. Rota re Tax status of Bank bonds.

23. Letter dated April 22 1976 from Mr. Guttentag to Mr. Scott enclosing memorandum IBRD Federal Income Tax Aspects of Investment in IBRD Obligations.

24. Letter dated June 23, 1978 from Mr. Guttentag regarding the effect of Repos transactions on the IRS ruling of November 20, 1974.

cc - Mr Ratberg
Mr. Scott
Mr. Broches (o/r)
Mr. Dood

SURREY, KARASIK AND MORSE

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WRITER'S DIRECT DIAL NUMBER
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June 23, 1978

International Bank for
Reconstruction and Development
1818 H Street, N.W.
Washington, D.C. 20433

Attention: Lester Nurick, Esquire

Gentlemen:

You have asked for our opinion with respect to whether the entry by the IBRD into repurchase agreements ("Repos") with United States commercial banks will adversely affect the continued validity of the ruling received by the IBRD from the Internal Revenue Service, dated November 20, 1974, to the effect that interest on the IBRD's obligations is income from sources without the United States. It is our opinion that participation by the IBRD in such Repo transactions should not alter the validity of the ruling as to the source of interest on its obligations.

A repurchase agreement is a device used by the IBRD to make short-term investments of idle funds. A Repo transaction involves the purchase of a stated face amount of securities -- typically Government securities, though commercial paper, banker's acceptances, or negotiable certificates of deposit are also used -- from a commercial bank (or banks). Simultaneously, the commercial bank agrees to repurchase the securities on a subsequent fixed date, ordinarily not more than 7 days later, at a price higher than that paid by the IBRD. The spread between the price paid by the IBRD and the price it receives is compensation for the commercial bank's use of the cash proceeds over the life of the Repo. This spread constitutes interest to the IBRD since the Internal Revenue Service has ruled, in Revenue Ruling 77-59, 1977-1 Cum. Bull. 196, that a Repo is essentially a loan transaction collateralized by the underlying securities; it is not treated for tax purposes as a purchase and sale of the securities.

24

In the private ruling issued to the IBRD in 1974, the Internal Revenue Service based its ruling that the IBRD's obligations generate foreign source interest on the fact that it was not engaged in commercial banking business within the meaning of section 861(a)(1)(C) of the Internal Revenue Code. Since the IBRD is a foreign corporation, section 861(a)(1)(C) provides that interest on its bonds is not treated as from sources within the United States so long as less than 50% of its gross income is effectively connected with the conduct of a trade or business within the United States. The IRS views regulation section 1.864-4(c)(5) as determinative of when a foreign corporation is engaged in the active conduct of a banking business in the United States. Regulation section 1.864-4(c)(5)(i) provides that the conduct of commercial banking activities in the U.S. includes, inter alia, receiving deposits of funds from the public, making personal, mortgage, industrial, or other loans to the public, and performing other banking services for the public. We represented in our ruling request that the IBRD did not engage in any of the activities described in regulation section 1.864-4(c)(5), and the IRS relied upon this representation in concluding that the IBRD was not engaged in the commercial banking business within the meaning of section 861(a)(1)(C).

We contested with the IRS the application of the standards of regulation section 1.864-4(c)(5) in the context of the 1974 ruling and continue to question the applicability of the regulation. In recent years, however, the IRS has strengthened its position with respect to this regulation by using it in the context of other Code sections, as discussed below. Accordingly, its applicability to the IBRD must be assumed. So long, therefore, as the IBRD's activities do not include any of those described in the section 1.864-4(c)(5) regulation, interest on its obligations should continue to be treated as from sources without the United States.

In private letter ruling 7806014 issued, we have learned, to the Federal Reserve Bank of New York on November 8, 1977, the IRS concluded that income from Repos entered into by foreign central banks of issue with the New York Fed fell within the purview of section 895 and was, therefore, exempt from federal income tax. Section 895 provides that income derived by a foreign central bank of issue from obligations of instrumentalities of the U.S. government is excluded from gross income unless the obligations are held for, or used in connection with, the conduct of commercial banking functions or other commercial activities. Such Repos were considered obligations of the New York Fed, an instrumentality of the United States government. The ruling concluded -- without analysis -- that the Repos were not held for, or used in connection with, the conduct of commercial banking functions and other commercial activities, and, accordingly, section 895 was held to exclude the income from the Repos from the gross income of the foreign central banks.

It is important for our purposes to analyze, though the ruling issued to the New York Fed did not, why ownership of Repos, admittedly a loan transaction, was not considered the conduct of a commercial banking function by the foreign central banks. The ruling stated as a fact that the Repo transactions were a way in which the foreign central banks invested portions of their monetary reserves and that such investments were considered "governmental activities" by U.S. standards. This implies that the investment of otherwise idle cash of the foreign central banks, entities which may engage in both governmental and commercial banking functions, was not incident to their commercial banking activities. The fact that the Repos are treated as loans rather than as the purchase of securities for investment, which is the holding of Revenue Ruling 77-59 discussed above, does not detract from this implication.

In Revenue Ruling 75-298, 1975-2 Cum. Bull. 290, the IRS held that a foreign central bank of issue qualified for the tax exemption afforded by section 892 (in addition to the section 895 exemption discussed above) so long as it did not engage in the United States in either commercial banking functions as described in regulation section 1.864-4(c)(5)(i) or in other commercial activities and met four other requirements. The fourth of such requirements is that "its investments in the United States, if any, include only those which produce passive income, such as currencies, fixed interest deposits, stocks, bonds, and <u>notes or other securities</u>

evidencing loans." (Emphasis added.) This indicates that the IRS concedes that, in certain circumstances, a loan can be a passive investment rather than a commercial banking activity within the meaning of regulation section 1.864-4(c)(5).

The IBRD utilizes Repo transactions for the short-term investment of funds not being used for its principal purpose -- the making of loans for productive reconstruction and development projects. Based on the above analysis, it is our opinion that when the IBRD enters into repurchase agreements with United States commercial banks, even though such transactions are technically classified as loans by the IBRD to such commercial banks, the IBRD should not be deemed to be engaged in a commercial banking function. The private ruling issued to the New York Fed indicates that when the IBRD enters into Repo transactions it is not carrying on a commercial banking activity. It is not "making personal, mortgage, industrial, or other loans to the public," within the meaning of regulation section 1.864-4(c)(5)(i)(b); it is simply making private investments for its own account. That "public" domestic commercial banks are the vehicle utilized to effect the Repo transactions does not impact on the analysis. Accordingly, the fact that the IBRD engages in Repo transactions with United States commercial banks should not adversely affect the ruling it previously received that interest on its obligations is treated as from sources without the United States.

It is our understanding that the IBRD also enters into Repo transactions with federal reserve banks, typically the New York Fed. As the New York Fed is a governmental entity, it is not the "public", and the IBRD in entering into the repurchase agreements with the Fed could not be said to be engaging in commercial banking activities.

Very truly yours,

SURREY, KARASIK AND MORSE

By: Joseph H. Guttentag

/ejw

FORM NO. 75
(7–73)

WORLD BANK GROUP

ROUTING SLIP	DATE

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	APPROPRIATE DISPOSITION		NOTE AND RETURN
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	FOR ACTION		PER YOUR REQUEST
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	INITIAL		RECOMMENDATION
	NOTE AND FILE		SIGNATURE

REMARKS

Please note last paragraph of memorandum.

FROM	ROOM NO.	EXTENSION
Hugh Scott		

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WRITER'S DIRECT DIAL NUMBER
202 331-4060

April 22, 1976

Hugh Scott, Esquire
International Bank for
Reconstruction & Development
1818 H Street, N.W.
Washington, D.C. 20433

Dear Hugh:

Enclosed is a Memorandum based on my telephone call today with George Beatty. I left his name out of the Memo in the event you wish to give a copy of it to Gene Rotberg and he in turn wishes to furnish it to the underwriters.

Sincerely yours,

Joseph H. Guttentag

Enclosure -

cc: Messrs. Nurick (o/r)
Rotberg
Deely
Heininger

23

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WRITER'S DIRECT DIAL NUMBER

202 331-4060

April 22, 1976

M E M O R A N D U M

TO: Files

FROM: Joseph H. Guttentag

RE: IBRD Federal Income Tax Aspects of Investment in IBRD Obligations

---

I received a telephone call today from a Washington tax attorney who was referred to me by Hugh Scott. The attorney's question was as follows:

Under the United States Internal Revenue Code, foreign corporations, even though controlled by U.S. corporations or individuals, are generally not subject to United States tax until their earnings are remitted to the United States shareholder in the form of dividends. Legislation enacted in 1962 affected such treatment by taxing certain earnings to United States shareholders of controlled foreign corporations as if the earnings had been distributed as dividends. Much of the 1962 Act was devoted to the taxation of so-called "tax haven" corporations. One provision of the law provides that earnings of controlled foreign corporations invested in United States property, are treated as if they had been distributed to U.S. shareholders as a dividend on a pro rata basis. Accordingly, if a foreign corporation which meets the definition of a controlled foreign corporation were to loan money to its shareholder, purchase stock of General Motors Corporation, or invest in U.S. realty, the increase in the investment in such U.S. property during the year would be treated as a dividend to the U.S. shareholder. This provision of the Internal Revenue Code (section 956) has been criticized as being contrary to the United States Balance of Payments objectives. A provision of the Tax Reform Act of 1975, presently pending before the Congress, would amend section 956 so as to permit generally investments in U.S. property other than loans to shareholders and property which is leased to a shareholder.

Under existing law, section 956 applies only to investments in "U.S. property", a defined term. Excluded from this definition are U.S. government obligations and bank deposits, as well as certain other technical exceptions of more limited application.

The term "U.S. property" is defined to include "an obligation of a U.S. person". The attorney's question was whether a controlled foreign corporation which acquired bonds or notes of the IBRD would be considered as having made an investment in U.S. property.

I advised the attorney that it was my informal opinion that IBRD obligations did not constitute U.S. property for the following reasons:

The term "U.S. person" is a defined term under the Internal Revenue Code, and means: (A) a citizen or resident of the United States; (B) a domestic partnership; (C) a domestic corporation, and (D) any estate or trust other than a foreign estate or foreign trust. The IBRD is not an estate or trust, nor is it a partnership. The term "citizen or resident" only refers to individuals, and not to corporations. Therefore, the only possible category into which the IBRD could fit would be that of a domestic corporation. A domestic corporation is defined under the Internal Revenue Code as one created or organized in the United States, or under the laws of the United States or any state or territory. The IBRD is organized under its Articles of Agreement, and not under the laws of the United States or any state or territory. Accordingly, it could not be a domestic corporation.

I told the attorney that my opinion was supported by the ruling issued on November 20, 1974 to the IBRD, which states that "the Bank, therefore, is not a United States person within the meaning of section 7701(a)(30) of the Code." This conclusion follows an analysis of the Internal Revenue Code substantially along the same lines as set forth above.

The attorney is aware that the ruling to which I referred would not necessarily be binding with respect to this particular issue since the Internal Revenue Service had not been requested to, and did not, address itself to the application of section 956. He was satisfied, however, as to the correctness of this conclusion, and told me that he intended to advise his client that the acquisition of IBRD bonds by a Swiss corporation controlled by United States shareholders, would not result in the shareholders being treated as if they had received a dividend from the Swiss company.

The attorney asked me whether I was aware of any reconsideration of the ruling by the Internal Revenue Service, and I told him that I was not.

The above result places the IBRD obligations in substantially the same category as United States governmental obligations and bank deposits for the purpose of section 956 of the Code. Under current market conditions, certain IBRD obligations may be a more attractive investment than U. S. Government obligations for corporations in this particular position. The attorney's inquiry was with respect to a prospective secondary market acquisition, but these tax consequences might be of interest to underwriters in connection with any future issue of IBRD obligations. I believe, however, that we are dealing with a relatively narrow market.

JHG:mr

22

Record Removal Notice

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File Title	Barcode No.
US Bond Issues - Taxes - 1964 to 1975	1850945

Document Date	Document Type
January 3, 1975	Memorandum

Correspondents / Participants
To: Mr. Georgio Rota, Executive Director for Italy
From: Piero Sella, Legal Department

Subject / Title
Tax Status of Bank Bonds

Exception(s)

Additional Comments
Declassification review of this record may be initiated upon request.

The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.

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Shiri Alon	September 30, 2021

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US Bond Issues - Taxes - 1964 to 1975	1850945

Document Date	Document Type
April 13, 1971 - Dec. 30, 1974	Correspondence

Correspondents / Participants
L. Nurick; Hugh Scott; Joseph Guttentag

Subject / Title
Tax ruling; foreign tax credit

Exception(s)
Attorney-Client Privilege

Additional Comments

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Withdrawn by	Date
Shiri Alon	September 30, 2021

Key Road Book 5119
Taxes

Internal Revenue Service
Washington, DC 20224

Date: APR 9 1971

In reply refer to:
T:I:C:3:1

Mr. Lewis Carroll
Cleary, Gottlieb, Steen & Hamilton
52 Wall Street
New York, New York 10005

In re: Asian Development Bank

Dear Mr. Carroll:

This is in reply to your request for rulings dated February 19, 1971, as supplemented by letter dated March 12, 1971, submitted in your capacity as General Counsel for, and on behalf of, the Asian Development Bank ("the Bank"). The ruling request concerns the exemption from United States Federal income taxation on income received by the Bank on investments in the United States, and the exemption from income and withholding tax on interest paid by the Bank to certain nonresident alien individuals, foreign corporations or foreign partnerships.

The information submitted indicates that the Bank is an international organization created by the Agreement Establishing the Asian Development Bank (the Agreement) which became effective on August 22, 1966. United States membership in the Bank was authorized by the Asian Development Bank Act, Public Law 89-369, 17 UST 1418, which was enacted March 16, 1966 (the Act). In addition, Executive Order 11334 designates the Bank as a public international organization entitled to enjoy the privileges, exemptions and immunities conferred by the International Organizations Immunities Act.

So used

The Bank's activities in the United States are limited to maintaining bank accounts and investments in short-term money market obligations, the offer, sale and qualification for investment of its obligations, and the designation of a fiscal agent in connection with the issuance of such obligations.

11

The Bank is presently contemplating the offer and sale of its obligations in the United States in the near future.

Section 892 of the Internal Revenue Code provides, in relevant part, that the income of foreign governments or international

Mr. Lewis Carroll

Based upon the facts and circumstances presented in the request for rulings, it is held that.

(1) The income received by the Bank on investments in the United States is exempt from United States Federal income taxation. Section 892.

(2) Based upon the provisions of paragraph 3(ii) of Article 56 of the Agreement, interest paid by the Bank to a non-resident alien individual or to a foreign corporation is not included in the gross income of such persons and is not subject to United States Federal income tax except that, absent any special statutory or treaty exemption, (a) such interest derived by such persons in the active conduct of a banking, financing or similar business within the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account, is subject to United States Federal income tax if such interest is attributable to an office or other fixed place of business of such persons within the United States and (b) a foreign corporation which is a life insurance company carrying on a United States insurance business is subject to United States Federal income tax on such interest if such interest is attributable to its United States business. Section 864(c)(4).

(3) No United States Federal income tax is required to be withheld on interest paid by the Bank or its United States fiscal agent to nonresident alien individuals, foreign partnerships or foreign corporations. Paragraph 1 of Article 56 of the Agreement.

Sincerely yours,

Actg John P. Clarke
Chief, Corporation Tax Branch

My Bond Book
Taxes

see letter from
Jos 6 Ap 19

MEMORANDUM

April 5, 1971

TO: Files

FROM: Joseph H. Guttentag

RE: Taxability of Interest Paid by the IBRD to Non-resident Aliens and Foreign Corporations

---

Interest paid by the bank is foreign source income for purposes of the Internal Revenue Code and is therefore not taxable to nonresident aliens and foreign corporations unless derived by such persons in the active conduct of a banking, financing or similar business within the United States, or received by a corporation, the principal business of which is trading in stocks or securities for its own account, or is attributable to the United States business conducted by a life insurance company.

If sole test is residence? ... can interest paid to anyone be taxable?

If the interest paid by the bank were held to be United States source income, different rules would apply. We have concluded that such interest is foreign source income for the following reasons:

Under the Code, interest is treated as from sources without the United States unless it is included within income from within the United States under § 861(a). Interest is treated as having its source generally under the Code depending upon the residence of the payor. Accordingly, interest paid by residents, corporate or otherwise, of the United States, is treated as United States source interest. The articles of agreement provide, in § 9(c)(ii) that no tax shall be levied on interest paid by the bank if the sole jurisdictional basis is the location of any office or place of business maintained by the bank. Accordingly, if the sole basis for determining that the interest paid on the bank's obligations is United States source interest is that the bank is a "resident" of the United States, such taxation is prohibited by the provisions of the article cited above.

What is the basis for a tax

Suppose US corp-law would deny ... a held co. ...

10

MEMORANDUM

April 5, 1971
Page 2.

What is meant by the exclusion

After including within the definition of United States source interest payments made by residents of the United States, the Code goes on to exclude from that definition, interest paid by a "foreign corporation", 50% or more of the gross income of which was effectively connected with the conduct of a trade or business in the United States, pro-rated, depending upon the percent of the total income so effectively connected.

In connection with the Asian Development Bank ruling, the Service is apparently considering the position that if more than 50% of the ADB's income is effectively connected, its interest may be taxable generally when received by nonresident aliens and foreign corporations. This position would appear to assume that the ADB is resident in the United States and therefore must come within one of the subsequent exclusions set forth in § 861(a). That test would also result in the imposition of tax on interest paid by the bank depending upon whether a portion of its income was effectively connected with a trade or business within the United States. Accordingly, such a test would run contrary to the requirements of the articles which prohibit such a test as the sole basis for taxation.

Since any theory under which the Internal Revenue Service would propose to tax the interest paid by the bank would be dependent upon the location of the bank within the United States, I believe such taxation would be prohibited by the articles. Furthermore, since the treatment of interest paid by the bank is dependent upon whether or not the bank is resident within the United States, and taxation cannot be imposed depending upon the bank's residence in the United States because of the articles, interest paid by the bank is properly denominated as foreign source interest rather than United States source interest -- that is, by classifying the interest paid by the bank as foreign source income, it will not be subject to United States taxation because of the bank's physical presence in the United States.

ORS File

M E M O R A N D U M

May 7, 1969

TO: Joseph H. Guttentag

FROM: Charles H. Gustafson

RE: IBRD - U.S. Withholding on IBRD Bond Interest

- -

The CCH Federal Tax Reporter contains the following statement:

> "The Internal Revenue Service will probably continue to hold that interest on bonds of the International Bank of Reconstruction and Development paid to a non-resident alien individual or a non-resident corporation is not subject to withholding under Code Sections 1441, 1442 and 1451."

No authority is cited for this statement. In response to my letter inquiring about the basis for the statement, CCH indicated that the statement is based upon a Special Ruling issued by the Treasury Department on November 24, 1947, and is supported by Sections 861(a)(1)(B) and 892 of the Internal Revenue Code. A copy of a letter to me from CCH dated April 16 and the 1947 Special Ruling are attached.

The Special Ruling concludes that interest paid on World Bank loans to non-resident alien individuals and foreign corporations not engaged in trade or business in the United States is not subject to taxation, and, therefore, not subject to withholding. The Special Ruling states that the IBRD is a separate jurdicial entity resident in the United States. It notes that the United States has a treaty obligation to refrain from levying a tax on "any obligation or security issued by the Bank

9

(including any dividend or interest thereon) by whomsoever held . . . if the sole jurisdictional basis for such taxation is the place or currency in which it is issued, made payable or paid, or the location of any office or place of business maintained by the Bank." Article VII (9) of the Articles of Agreement of the IBRD. To implement the obligation of the United States under the treaty, Congress has provided that income to the Bank from its United States investments are not to be deemed "gross income from United States sources". Non-resident alien individuals and foreign corporations not engaged in trade or business within the United States are subject to tax on interest only from sources within the United States. Interest from corporations will not be considered U.S. source income if less than 20% of the corporation's gross income is derived from U.S. sources. Since the gross income of the Bank includes no income from U.S. sources interest from the Bank will not be considered to be U.S. source income. Accordingly, interest payments to non-resident aliens or foreign corporations will not be subject to U.S. taxes. It is not, therefore, necessary for the Bank to withhold any U.S. taxes on such interest payments.

The Special Ruling was, of course, issued under the Internal Revenue Code of 1939. The provisions of the 1939 Code upon which the Special Ruling was based have essentially been carried over to the Internal Revenue Code of 1954. IRC Sec. 861(a)(1)(B) provides that interest from resident aliens or domestic corporations shall not be considered to be income from sources within the United States "when it is shown to the satisfaction of the secretary or his delegate that less than 20 percent of the gross income from all sources of such individual or such corporation has been derived from sources within the United States". While the Bank is neither a "resident alien individual" nor a "domestic corporation", CCH must conclude that the Bank, as a "separate juridical entity", comes within the ambit of this provision.*

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* Section 861(a)(1)(C) provides that interest paid by a foreign corporation will be considered to be from U.S. sources only if more than 50% of the gross income of the corporation was effectively connected with the conduct of a U.S. trade or business.

IRC Section 892 provides that "the income of . . . international organizations received from investments in the United States in stocks, bonds, or other domestic securities . . . or from interest on deposits in banks in the United States . . . or from any other source within the United States, shall not be included in gross income and shall be exempt from taxation."

Non-resident aliens and foreign corporations are subject to withholding tax on interest only "to the extent that [it] . . . constitutes gross income from sources within the United States", unless it is effectively connected with the conduct of a trade or business within the United States. IRC Sec. 1441(a). As long as the Bank receives less than 20 percent of its gross income from sources within the United States, therefore, CCH would conclude that the interest which it pays will not be subject to U.S. withholding taxes.

The CCH analysis is dependent upon the characterization of the Bank under the Code as a resident alien or a corporation. The Bank is, of course, technically neither. It is an international organization which conducts banking operations primarily in the United States. The CCH conclusions can be justified, as it was in the 1947 Special Ruling, by reference to the obligation to refrain from taxing imposed on the U.S. by the treaty and the assumption that Congress intends to give effect to those treaty provisions. While this reasoning is sound, there is sufficient ambiguity in the language of the Code to warrant consultations with the Treasury should the question arise anew.

CHG/kwg

Record Removal Notice

File Title	Barcode No.
US Bond Issues - Taxes - 1964 to 1975	1850945

Document Date	Document Type
13 May, 1968	Memorandum

Correspondents / Participants
To Files
From: Thomas M. Clyde

Subject / Title
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The Effectively Connected Concept in the Foreign Investors Tax Act of 1966

By JAMES SITRICK

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The Effectively Connected Concept in the Foreign Investors Tax Act of 1966

By JAMES SITRICK

The Foreign Investors Tax Act of 1966 embodies the most comprehensive revision of the application of the U. S. tax system to income derived from investment in the United States by foreign taxpayers since the inception of our tax laws. A central feature of this revision is the addition to the Internal Revenue Code of the "effectively connected" concept, the implications of which permeate many of the changes made by the Act. This article, derived from a speech delivered by the author before the Tax Executives Institute in New York City on November 9, 1966, is a succinct summary of the history of the concept and a description of the manner in which it is used in the new Act. James Sitrick is a member of the Office of Tax Legislative Counsel (International) of the Treasury Department, Washington, D. C.

UNDER PRE-1967 LAW, nonresident alien individuals and foreign corporations (foreign taxpayers) were subject to U. S. income tax only on income considered derived from sources within the United States under the detailed source rules contained in the Code,[1] whether or not such taxpayers were considered to be engaged in trade or business within the United States. If a foreign taxpayer was considered to be engaged in a U. S. trade or business, U. S. tax at the same rates applicable to U. S. citizens (in the case of nonresident alien individuals, foreign partnerships and foreign trusts) and domestic corporations (in the case of foreign corporations) was imposed on all such a taxpayer's income considered to be from U. S. sources (including capital gains),[2] even though some of such income was not derived from the conduct of such trade or business. Under this concept of taxation, which is sometimes referred to as the "force of attraction" principle, investment income derived by a foreign taxpayer was attracted to the permanent establishment or trade or busi-

[1] I. R. C. Secs. 861-863.

[2] I. R. C. Secs. 871(c), 872 and 882, prior to the amendment of such sections by the Foreign Investors Tax Act of 1966.

ness of the foreign taxpayer in the United States, and such business and nonbusiness income was aggregated and subjected to U. S. income tax at the regular rates applicable to the siness income. This has been the ·anner in which the United States ɹs taxed income derived by foreign taxpayers from U. S. investment for the last 30 years.[3]

OECD Model Income Tax Convention

In 1963, the Fiscal Committee of the Organization for Economic Cooperation and Development (OECD) [3a] published a model Draft Double Taxation Convention on Income and Capital. On page 80 of the Report of the OECD Fiscal Committee on that model draft, it is stated:

"Some countries have taken the view that when a foreign enterprise has set up a permanent establishment within their territory it has brought itself within their fiscal jurisdiction to such a degree that they can properly tax all profits that the enterprise derives from their territory, whether the profits come from the permanent establishment or from other activities in that territory . . . it is thought that ¨ is preferable to adopt the principle . based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the fiscal authorities of that country should look at the separate sources of profit that the enterprise derives from their country and should apply to each the permanent establishment test."

Thus, the model draft provides that business profits of an enterprise of one country may be taxed in another country in which such an enterprise has a permanent establishment only if such business profits are "attributable to that permanent establishment";[4] and that the treaty benefits otherwise accorded to dividends, interest and royalties received by such an enterprise from the country in which the enterprise maintains a permanent establishment shall be available to the enterprise only if such income is not "effectively connected" with such permanent establishment.[5]

The publication of the OECD model draft in 1963 indicated general international acceptance among the developed countries of the Western World of the method for taxing income from foreign investment set forth in that draft, which clearly abandoned the "force of attraction" principle described above.

Fowler Task Force Proposal

In his Balance of Payments Message of July 18, 1963, President Kennedy announced that he would appoint a Task Force to review U. S. government and private activities which might be adversely affecting foreign purchases of securities of U. S. companies. In April 1964, the Task Force issued a Report to the President con-

[3] Prior to the Revenue Act of 1936, U. S. tax law contained no distinction between foreign taxpayers engaged in business in the United States and those not so engaged. Instead the entire net income of all foreign taxpayers, including capital gains, was subject to U. S. income tax. See Revenue Act of 1934, Ch. 277, 48 Stat. 680, Secs. 11, 12(b), 13(a), 212(a), 213, 231(a). Since the 1936 Act, foreign taxpayers not engaged in business in the United States have been taxed only on "fixed or determinable annual or periodical income," a concept which has been part of the withholding provisions of the Code since 1913. Revenue Act of 1913, Ch. 16, Section II, 38 Stat. 168.

[3a] The member countries of the OECD are Austria, Belgium, Canada, Denmark, Federal Republic of Germany, France, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

[4] See Article 7, ¶ 1 of the OECD Draft Double Taxation Convention on Income and Capital.

[5] See Article 10, ¶ 4 (Dividends), Article II, ¶ 4 (Interest) and Article 12, ¶ 3 (Royalties) of the OECD Draft Double Taxation Convention on Income and Capital.

taining 39 recommendations.[6] Recommendation number 32 of that Report urged that foreign persons engaged in trade or business within the United States be taxed at regular U. S. income tax rates only on "income connected with such trade or business." The Report stated the reason for such a recommendation was that the law then in effect "certainly deters foreign businessmen operating in the United States from becoming investors in the United States, and may also deter foreigners already investing in the United States from commencing a trade or business here." [7]

The Task Force Report prompted a broad and intensive review by the Treasury Department of the rules governing the U. S. taxation of nonresident aliens and foreign corporations. Following this review, on March 8, 1965, the Treasury Department submitted to the Congress H. R. 5916 which contained proposals dealing with all the matters discussed in the Task Force Report, notably in the case of individual foreign taxpayers, the principle relating to the taxation of income from foreign investment in the United States in accord with the OECD and the Fowler Task Force proposals. The House Ways and Means Committee thoroughly considered H. R. 5916, and, after holding public hearings, Chairman Mills introduced a new version of the bill (H. R. 11297) on September 28, 1965. Among other things, that bill proposed that for the first time nonresident aliens and foreign corporations engaged in trade or business within the United States should be subject to U. S. income tax at regular rates on taxable income "effectively connected" with the conduct of such trade or business, regardless of the technical source of such income, and set forth certain factors to be taken into a count in determining whether incom gain or loss was effectively connect with a trade or business carried on within the United States by a foreign taxpayer.[8]

The public comments received on H. R. 11297 interposed numerous objections to what some taxpayers considered to be an extension of U. S. jurisdiction to tax income of foreign taxpayers.[9] After extensive consideration of H. R. 11297, the House Ways and Means Committee retained the concept of separating business from nonbusiness income but modified H. R. 11297 in other respects, that is, *inter alia,* the Committee shifted the weight to be accorded the factors to be used in determining whether income of a foreign taxpayer is effectively connected and concluded that at the present time the U. S. imposition of an income tax on income having its technical source abroad but generated by U. S. business activities of foreign taxpayers should be limited to those kinds of foreign source income whic under the rules of source contain in Sections 861-964 of the Internal Revenue Code, permit the use of the United States as a kind of "tax haven," or prevent the United States from obtaining a reasonable income tax from business activities generated in the United States.[10]

Consequently, on February 28, 1966 the House Ways and Means Commit-

[6] Report to the President of the United States From the Task Force on Promoting Increased Foreign Investment in United States Corporate Securities and Increased Foreign Financing for United States Corporations Operating Abroad (April 27, 1964).

[7] Cited at footnote 6, at p. 27.

[8] See Sections 864(c), 871(b) and 882 of H. R. 11297, introduced in the House of Representatives on September 28, 1965.

[9] See Hearings Before the Committee on Ways and Means on H. R. 11297, United States House of Representatives, 89th Congress, 1st Sess.

[10] See H. Rept. 1450, 89th Congress, 2nd Sess., p. 14-15.

tee introduced another version of the bill (H. R. 13103) which, among other things, incorporated the OECD and Fowler Task Force principle of separating business income from nonbusiness income for purposes of taxing income derived by foreign taxpayers from investment in the United States, and in addition proposed to tax foreign persons on income to which the Code ascribes a foreign source and which is generated by U. S. business activities of such persons only if derived from three limited categories of activities. Public hearings on H. R. 13103 were held on March 7, 1966, and the Foreign Investors Tax Act of 1966 was reported favorably out of the House Ways and Means Committee on April 26, 1966 and passed the House of Representatives on June 15, 1966.

The Senate Finance Committee then considered the bill and on October 11, after adding certain amendments to it which affected only slightly the original provisions of the bill regarding foreign taxpayers, reported it favorably to the Senate. The provisions of the Act relating to the "effectively connected" concept were not changed after the bill was reported by the Senate Finance Committee. However, a reconciliation of other differences between the final House and Senate versions of the bill then ensued, and the bill was passed on October 22 and was signed by the President on November 13, 1966.

H. R. 13103

"*Effectively Connected*" *Concept—Two Functions*

Under the provisions of the new Act, the phrase "effectively connected" serves two important, but quite different, functions. First, it is the statutory concept used to distinguish business income from nonbusiness income of foreign persons engaged in business in the United States, thus implementing the recommendation of the Fowler Task Force that only the former be subject to U. S. income tax at regular graduated rates.[11] Second, it is the concept, as statutorily defined, used to describe the only income generated by U. S. business activities of foreign taxpayers, and to which the Code ascribes a foreign source, which is subject to U. S. income tax under the Code—the three limited categories of foreign source income of foreign persons which may be subject to U. S. income tax under the new law may be so taxed only if such income is "effectively connected" with the conduct by the recipient of a trade or business within the United States.[12]

"*Engaged in Trade or Business*" *Test*

It should be noted at the outset that the "effectively connected" concept is applicable only in determining the U. S. income tax liability of foreign persons engaged in trade or business in the United States.[13] Foreign persons not so engaged are subject to U. S. income tax only on "fixed or determinable annual or periodical" income (and, in the case of certain nonresident aliens, capital gains) [14] derived from sources within the United States, in substantially the same manner as under prior law.[14a] Thus, in determining whether the "effectively connected" concept applies under the new law, an initial determination must be made as to whether the foreign

[11] Footnote 7 and the text to which it relates.

[12] I. R. C. Sec. 864(c)(4)(B).

[13] I. R. C. Sec. 864(c)(1)(A).

[14] I. R. C. Sec. 871(a)(2).

[14a] I. R. C. Secs. 871(a)(1) and 881. The new Act added to prior law Sections 871(a)(1)(C) and 881(a)(3) relating to the taxation of certain gains under Section 1232 of

(*Continued on following page.*)

taxpayer is engaged in trade or business within the United States for U. S. tax purposes. With respect to such a determination, the Act directly changes prior law in only one respect, that is, where a foreign person trades in securities or commodities in the United States, and in this case the Act has a substantial liberalizing effect.[15] In all other cases, the Act does not directly alter the rules for determining whether a foreign person is engaged in trade or business within the United States,[16] although the effect of the new concept may be either to decrease or increase the importance of that determination in certain cases. A foreign taxpayer who is uncertain whether his present activities in the United States render him engaged in trade or business within the United States for tax purposes, for example, where a foreign taxpayer utilizes the services of an independent contractor to solicit U. S. sales orders for the taxpayer's product, may make an unrelated nonbusiness investment in the United States without fear that the income from such investment will be subject to U. S. income tax at regular graduated rates, or that any potential capital gain realized from such investment will be subject to U. S. tax.

On the other hand, the effect of the new concept may be to increase the importance of the "engaged in trade or business" determination in certain cases. Thus, because pre-1967 law imposed U. S. income tax on a foreign person only with respect to income considered to be from U. S. sources, if such a person received foreign source income such income was not subject to U. S. income tax and whether the recipient was engaged trade or business within the Unite States was of only academic impo tance. However, since the new Act provides for the U. S. taxation of certain foreign source income of foreign persons engaged in trade or business within the United States, the fact that such a foreign person may receive foreign source income does not *ipso facto* prevent the United States from imposing an income tax on such income, and further consideration may have to be given to whether such a taxpayer is engaged in trade or business in the United States through an office or other fixed place of business for tax purposes.

The new law also provides that the three limited categories of foreign source income generated by U. S. business activities of foreign taxpayers which may be subject to U. S. income tax are never to be treated as effectively connected with the conduct of a U. S. trade or business by a foreign taxpayer unless such taxpayer "has an office or other fixed place of bu ness within the United States to wh such income . . . is attributable."[17] This "office or other fixed place of business" test is similar to the "permanent establishment" standard contained in international treaties for the

(*Footnote 14a continued.*)
the Code, and Sections 871(a)(1)(D) and 881(a)(4), relating to certain gains from the sale or exchange of intangible property.

[15] I. R. C. Sec. 864(b)(2).

[16] The Act indirectly alters the "engaged in trade or business within the United States" test of prior law by permitting foreign taxpayers to elect to treat certain income from real property as effectively connected with the conduct of a trade or business within the United States, Sections 871(d) and 882(a); and by permitting certain banking corporations created or organized in a possession of the United States to treat interest on obligations of the United States as effectively connected with the conduct of a trade or business within the United States, Section 882(e). In such cases, the effect is to permit such taxpayers to be taxed in the United States on such income on a net basis, that is, to deduct certain expenses connected with income subject to U. S. income tax, which expenses otherwise would not be deductible for U. S. income tax purposes. See Sections 873(a) and 882(c)(1)(A).

[17] I. R. C. Sec. 864(c)(4)(B).

avoidance of double taxation[18] and requires a greater level of activity within the United States by a foreign taxpayer than does the engaged in trade or business test as a condition imposing U. S. income tax on any foreign source income of such a taxpayer. Thus, where a foreign taxpayer uses an independent U. S. agent acting in the ordinary course of his business, that is, an agent economically independent of the foreign taxpayer, to solicit U. S. orders regularly for goods produced abroad by the taxpayer, the foreign taxpayer might be considered to be engaged in trade or business in the United States but generally would not be considered to have an office or fixed place of business in the United States. Accordingly, in such a case no foreign source income of the foreign taxpayer, even though attributable to the taxpayer's U. S. business activities, could be subject to U. S. income tax under the Act.

Taxation of Income Not Effectively Connected with Conduct of Trade or Business

If it is determined that a nonresident alien or foreign corporation is engaged in trade or business within the United States for tax purposes, the taxpayer is required to separate income subject to U. S. tax into two categories: (1) income which is effectively connected with the conduct of a U. S. trade or business by the taxpayer, and (2) income which is not so effectively connected. The latter is taxed in the same manner as it would be if the foreign taxpayer were not engaged in a U. S. trade or business.[19]

Thus all fixed or determinable income from U. S. sources which is not considered effectively connected with the conduct of a trade or business with the United States by a foreign taxpayer will be subject to a withholding tax of 30 per cent of the gross amount of such income;[20] and such 30 per cent rate may be reduced if the recipient of such income is a resident or corporation of a foreign country which is a party to an income tax convention with the United States.[21]

Under some existing income tax conventions to which the United States is a party, a resident or corporation of the foreign Contracting State is not entitled to the benefits accorded by the convention if such person maintains a permanent establishment in the United States.[22] Such income tax conventions reflect the "force of attraction" principle described above which was a part of our internal tax law prior to the Foreign Investors

[18] Thus, the "office or other fixed place of business" concept is not new to U. S. tax counselors. The term "permanent establishment" has been used in our tax treaties with foreign countries for about 30 years. Moreover, the language of the statute parallels the OECD model draft of double tax convention. The convention provides that a permanent establishment shall be taxed on income attributable to it. The Act does not use the term "permanent establishment", but uses the same words used to define "permanent establishment," that is, "office or other fixed place of business"; and, just as in the OECD model, the Act taxes income attributable to such officers. However, under the OECD model these rules apply to all income whereas under the Act such taxation is far more limited. See footnotes 38-53 below and the text to which they relate. Compare, for example, Article 2 of the Protocol modifying the Convention between the Federal Republic of Germany and the United States, CCH TAX TREATIES ¶ 3026.

[19] I. R. C. Secs. 864(c)(1)(B), 871(a)(1) and 881.

[20] I. R. C. Secs. 871(a)(1) and 881.

[21] I. R. C. Sec. 7852(d).

[22] See, for example, Articles VII (1) and VIII (1) of the Income Tax Convention between the United States and Italy, CCH TAX TREATIES ¶ 4310, 4311; and Articles VI (1), VII (1) and VIII (1) of the Income Tax Convention Between the United States and Switzerland, CCH TAX TREATIES ¶ 7410, 7411.

Tax Act.[23] New Section 894(b) of the Code provides, however, that for purposes of determining the U. S. tax on items of income not effectively connected with the conduct of a U. S. trade or business by the recipient, a nonresident alien individual or foreign corporation shall be deemed, for purposes of applying the provisions of an income tax convention to which the United States is a party, not to have a permanent establishment in the United States at any time during the taxable year. Therefore, a nonresident alien individual who is a resident or foreign corporation of a foreign country which is a party to an income tax convention with the United States will receive the benefit of any exemption from, or reduction in rate of, tax applicable under the convention to specific items of nonbusiness income even though under the terms of the convention such person is engaged in trade or business through a permanent establishment situated in the United States.

For example, assume that an Italian corporation operates a manufacturing plant in the United States and also receives quarterly dividends from an equity investment in General Motors common stock, which dividends are not effectively connected with the Italian corporation's U. S. manufacturing business. Article VII (1) of the income tax convention presently in force between the United States and Italy provides that the maximum rate of tax of 15 per cent specified therein shall apply to dividends received from a U. S. corporation only by an Italian corporation "not having a permanent establishment in the [United States]." However, under the provisions of new Section 894(b) and Section 10 [24] of the Act, the Italian corporation is deemed not to have a permanent establishment in the United States for purposes of applying the terms of the U. S.-Italian income tax convention; and, accordingly, the Italian corporation may receive the General Motors dividends subject only to the 15 per cent rate of U. S. tax prescribed in Article VII (1) of such convention.

Taxation of Income Effectively Connected with Conduct of a U. S. Trade or Business

Sections 871(b)(1) and 882 provide for a tax, to be computed at the graduated rates applicable to U. S. citizens, residents and domestic corporations, on the taxable income of nonresident alien individuals or foreign corporations which is effectively connected with the conduct of a trade or business within the United States by such individuals or corporations. As previously indicated, this tax applies only if the foreign taxpayer is engaged in trade or business within the United States at some time during the taxable year for which the tax is being imposed.[25] Moreover, such tax is imposed on the taxable income of the foreign taxpayer which is effectively connected with any trade or business carried on by such taxpayer 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 tax-

[23] Pp. 2 and 3.

[24] Section 10 of the Act provides that "No amendment made by this title shall apply in any case where its application would be contrary to any treaty obligation of the United States. For purposes of the preceding sentence, the extension of a benefit provided by any amendment made by this title shall not be deemed to be contrary to a treaty obligation of the United States."

[25] Fotnote 13 and the text to which it relates.

payer.[26] Any income of a foreign taxpayer which is not effectively connected with a U. S. trade or business is not to be taken into account in determining the tax imposed on such person's business income, even though such income may not be subject to the 30 per cent tax imposed on nonbusiness income.[27] Thus noneffectively connected capital gains will not be subject to U. S. income tax when received by a foreign corporation, or by a nonresident alien individual who is present in the United States for less than 183 days during the taxable year in which such income is realized.[28]

Section 864(c) contains guidelines for determining whether income of a nonresident alien or foreign corporation engaged in a U. S. trade or business is effectively connected with the conduct of such business. The guidelines divide the business income in respect of which the effectively connected determination is to be made into the following three general classes: (1) fixed or determinable income from sources within the United States;[29] (2) other income from sources within the United States;[30] and (3) income from sources without the United States.[31]

U. S. Source Fixed or Determinable Effectively Connected Income.—In the case of income described in Section 871(a)(1) or Section 881(a)[32] ("fixed or determinable income") from courses within the United States, the factors applicable to determining whether such income is effectively connected with the conduct of a trade or business within the United States are:

(a) Whether the income, gain or loss is derived from assets used in, or held for use in, the conduct of the U. S. trade or business;[33] and

(b) Whether the activities of the U. S. trade or business are a material factor in the realization of the income, gain or loss.[34]

In applying these two factors, due regard also is to be given to whether such asset or such income, gain or loss was accounted for through such U. S. trade or business, for example, is carried on books of account separately kept for the U. S. trade or business.[35] However, in determining whether fixed or determinable income from sources within the United States is effectively connected with the conduct of a U. S. trade or business by a nonresident alien or foreign corporation, particular attention will be given to the first factor, that is, whether the asset giving rise to such income, gain or loss is used in, or held for use in, such trade or business. This is because that factor is particularly important in the case of investment-type income, where business activities are not likely to be a material factor in the realization of such income.[36]

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[26] Thus if a foreign taxpayer discontinues a trade or business conducted in the United States in 1967 but receives deferred income effectively connected with such a business in 1969, during which latter year such taxpayer is engaged in a different trade or business within the United States, the income so received is subject to tax at the regular rates applicable to the business income of the foreign taxpayer. See I. R. C. Secs. 871(b), 882; H. Rept. 1450, 89th Cong., 2nd Sess., p. 72.

[27] H. Rept. 1450, 89th Cong., 2nd Sess., p. 73.

[28] I. R. C. Secs. 871(a)(2) and 881.

[29] I. R. C. Sec. 864(c)(2).

[30] I. R. C. Sec. 864(c)(3).

[31] I. R. C. Sec. 864(c)(4).

[32] The only difference between the items of income described in Section 871(a)(1) and those described in 881(a) is that the latter does not apply to gains described in Sections 402(a)(2), 403(a)(2) and gains on transfers described in Section 1235.

[33] I. R. C. Sec. 864(c)(2)(A).

[34] I. R. C. Sec. 864(c)(2)(B).

[35] I. R. C. Sec. 864(c)(2), penultimate sentence.

[36] H. Rept. 1450, 89th Cong., 2nd Sess., p. 58.

To illustrate this principle the House Ways and Means Committee Report contains an example which assumes that a foreign corporation is engaged in manufacturing operations through its U. S. branch. In order to secure a constant source of supply for its U. S. factory, the foreign corporation purchases stock in a domestic corporation. Dividends received by the foreign corporation from the domestic corporation will be considered effectively connected with the U. S. business of the foreign corporation since the stock of the domestic corporation is held for use by the foreign corporation in the conduct of its U. S. manufacturing business.[37]

In determining whether an asset of the foreign taxpayer which generates fixed or determinable income is effectively connected with a U. S. business conducted by the taxpayer, primary consideration will be given to the relationship between the asset and the needs of the U. S. business.[37a] In this connection, factors to be considered may include (1) the source of the money used to acquire the asset which generates the fixed or determinable income, (2) the disposition of such income, and (3) the extent of management and control of such asset by the U. S. business.[37b] Moreover, where the U. S. business of the foreign taxpayer generates the income used to acquire an asset, where the U. S. business office of the foreign taxpayer manages and controls significant economic decisions regarding such asset, and where the income from such asset is used or held for use in such business, the asset and the fixed or determinable income which it generates will be considered effectively connected with the foreign taxpayer's U. S. business without regard to the needs of the U. S. business.[37c]

The basic principle of separating business from nonbusiness income of foreign taxpayers for U. S. tax purposes is a fairly simple one. Moreover, while the "effectively connected" concept used to implement such a method of taxation is new and may be uncertain in its application in some cases, this has been equally true under prior law where vast U. S. tax consequences turned on the interpretation of the vague phrase "engaged in trade or business in the United States." Thus, under prior law if a foreign lawyer came to the United States to negotiate a transaction for a client, he was considered engaged in trade or business in the United States and all his U. S. source income was subject to U. S. tax at graduated rates. This result obtained although the foreign lawyer's legal fee was $1,000 and his U. S. investment income was $15,000. Consequently, prior law tended often to create distorted economic situations.

The House Ways and Means Committee Report on the Act gives considerable guidance concerning the application of the factors used in the Act so as to permit taxpayers to arrange their affairs in a manner designed to avoid difficult interpretative problems. In addition, it is intended that such factors will be amplified in greater detail in Proposed Regulations presently being considered under Section 864. Moreover, since similar questions exist under our more recent treaties, the Treasury simultaneously is attempting to coordinate new treaty regulations with those to be proposed under the new Act.

Other U. S. Source Effectively Connected Income.—In the case of in-

[37] H. Rept. 1450, 89th Cong., 2nd Sess., p. 59.

[37a] H. Rept. 1450, 89th Cong., 2nd Sess., p. 59.

[37b] H. Rept. 1450, 89th Cong., 2nd Sess., p. 59.

[37c] H. Rept. 1450, 89th Cong., 2nd Sess., p. 59.

come from sources within the United States other than fixed or determinable income, the Act provides that all such income shall be considered to be effectively connected with the conduct of a U. S. trade or business by a nonresident alien or foreign corporation during the taxable year in which such person is engaged in business in the United States.[38] Consequently, the Act does not change present law concerning the taxation of income from U. S. sources derived by a foreign taxpayer engaged in trade or business within the United States if such income is not fixed or determinable income, or gain from the sale or exchange of capital assets.

A principal effect of this provision is to tax income derived by a foreign person engaged in trade or business in the United States from sporadic inventory sales, the income from which is considered to have a U. S. source. Thus assume that a foreign manufacturing company establishes a U. S. branch to market its manufactured products in the United States, and that the foreign manufacturing branch occasionally makes mail order sales of such products directly to U. S. consumers, with title to such goods passing in the United States. The income derived from such mail order sales by the foreign branch of the foreign corporation will be considered effectively connected with the sales business conducted by the U. S. branch of the corporation whether or not such income is considered as derived from assets used in, or held for use in, the conduct of the U. S. sales business of the foreign corporation, and without regard to whether the activities of the U. S. sales business are a material factor in the realization of such sales income.[38a]

Foreign Source Effectively Connected Income.—In the case of income which under the source rules of the Code is considered to be from sources without the United States, the Act provides that only three limited categories of income can be considered effectively connected with the conduct of a U. S. trade or business by a foreign taxpayer.[39] Moreover, as previously indicated, no foreign source income of a foreign taxpayer engaged in trade or business within the United States is to be considered effectively connected with a U. S. trade or business of the taxpayer unless such foreign taxpayer maintains an office or other fixed place of business within the United States.[40] Except for such three limited categories of income (and certain income of foreign life insurance companies), no income to which the source rules of the Code ascribe a source without the United States is to be treated as effectively connected with the conduct by a foreign person of a trade or business within the United States.

The three categories of foreign source income generated by U. S. business activities of foreign taxpayers which may be considered effectively connected with the conduct by a foreign person of a U. S. trade or business through a U. S. office or other fixed place of business under the Act are:

[38] I. R. C. Sec. 864(c)(3).

[38a] I. R. C. Sec. 864(c)(3). Compare Article III (1) of the Income Tax Convention between the U. S. and the Federal Republic of Germany, as amended by the protocol ratified on December 27, 1965, CCH TAX TREATIES ¶ 3006, which provides that if an enterprise of one country maintains a permanent establishment in the other country, the latter country may tax the profits attributable to such permanent establishment and the profits from the sale of goods of the same kind as those sold, or from other business transactions of the same kind as those effected, through the permanent establishment.

[39] I. R. C. Sec. 864(c)(4)(B).

[40] Footnote 17 and the text to which it relates.

(a) Rents or royalties received in consideration for the use of or for the privilege of using intangible property described in Section 862(a)(4)[41] —including any gain or loss realized on the sale of such property—derived in the active conduct of a trade or business within the United States.[41a]

Under pre-1967 law a foreign corporation could establish its principal office in the United States and license patents or other intangible property developed or purchased by such foreign corporation (either in the United States or abroad) to foreign licensees. All the activities surrounding the solicitation, negotiation and other arrangements leading to the conclusion of such licensing agreements might occur in the U. S. office of such foreign corporation. However, because the licensee in such a case was a foreign person (and, accordingly, the intangible property used by such licensee was located and used abroad), the source rules in the Code characterize the income from such licenses as foreign source royalty income of the foreign corporation.[42] Consequently, because pre-1967 law prevented the United States from imposing a U. S. income tax on any income of foreign taxpayers to which the source rules contained in the Code ascribe a foreign source, such royalty income was not subject to U. S. tax. This result obtained notwithstanding the fact that all activities generating the royalty income occurred in the U. S. office of the foreign corporation, which was the principal office (and may have been the only office) of such foreign corporation.

Under the Act rents or royalties derived from foreign licensees will be considered effectively connected to a U. S. trade or business conducted by foreign taxpayers if the lease or license generating such income is made by or through an office or fixed place of business maintained by the foreig taxpayer within the United States For this purpose, a lease or license i to be treated as made by or through a business office or other fixed place of business in the United States only if such U. S. office or 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. Thus the fact that license agreements concluded by a foreign office of a foreign corporation, which corporation is also engaged in a licensing business through a U. S. branch office, may be subject to the approval of an executive officer of the corporation (which approval rarely is withheld) who maintains his office in the U. S. branch of such foreign corporation, will not cause the income derived from such license agreements to be characterized as effectively connected with the U. S. licensing business of such corporation.[43] Moreover, no such rent royalty income will be considereu effectively connected with a U. S. trade or business of a foreign taxpayer merely because the U. S. office of such taxpayer develops or otherwise acquires the property which generates such income.[44]

(b) The second category of foreign source income of a foreign person who maintains an office or other fixed place of business in the United States

[41] The intangible property referred to in Section 862(a)(4) is patents, copyrights, secret processes, formulas, good will, trademarks, trade brands, franchises and other like property.

[41a] I. R. C. Sec. 864(c)(4)(B)(1).

[42] I. R. C. Sec. 862(a)(4).

[43] H. Rept. 1450, 89th Cong., 2nd Sess., Example p. 65.

[44] H. Rept. 1450, 89th Cong., 2nd Sess., Example p. 65.

which may be considered effectively connected with such U. S. business under the Act is dividends, interest, or gain or loss from the sale or exchange of stock or notes, bonds or ther evidence of indebtedness de-ived in the active conduct of a bank-ng, financing or similar business within the United States by a 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 [45]

In general, the "active conduct of a banking, financing or similar business" and "office or other fixed place of business" tests contained in Section 864(c)(4)(B)(ii) are intended to include only U. S. branch offices or agencies of a foreign bank, and to exclude offices of a correspondent bank or bank representative.[45a]

Moreover, the income described in Section 864(c)(4)(B)(ii) generally shall not include income from stocks or securities which are purchased for investment purposes only. In this connection, the House Ways and Means Committee Report on the Act provides that a foreign holding company, the principal activity of which s holding a significant percentage of the oting stock of other corporations, will not be considered to have as its principal business trading in stocks or securities for its own account.[46]

Under pre-1967 law, a U. S. branch of a foreign financial corporation paid no U. S. income tax on interest derived from loans made by the U. S. branch of such corporation to borrowers in foreign countries. This was because under the rules of source contained in the Code the source of interest earned on such loans generally is considered to be the country in which the debtor is resident.[47] Accordingly, under pre-1967 law income generated entirely by lending activities performed by the U. S. branch of a foreign financial institution was subject to no U. S. income tax. Under the Act, such interest income will be subject to U. S. income tax when derived for a foreign taxpayer in the active conduct of a banking business through a U. S. office or fixed place of business.

A similar situation obtained under pre-1967 law in the case of a foreign investment company which traded in stock and securities through a U. S. office. Dividend and interest income derived by such a foreign investment company from stock or security investments in foreign corporations generally is considered to be foreign source income [48] and, accordingly, prior to the new Act such income was not subject to U. S. tax. As in the case of the licensing company described above, this was so notwithstanding the fact that the day-to-day management of the foreign investment company, and all decisions relating to the purchase and sale of stock or securities by such foreign investment company, occurred in the U. S. office of the United States. Under the new law such dividend and interest income will be subject to U. S. income tax when derived by a foreign investment company (1) if such a foreign corporation maintains its principal office in the United States, and (2) is not a personal holding company.[49]

(c) The final category of foreign source income generated by U. S.

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[45] I. R. C. Sec. 864(c)(4)(B)(ii).

[45a] In this connection, see also Section 864(c)(5)(A), relating to when an office of an agent may constitute the office of a foreign taxpayer.

[46] H. Rept. 1450, 89th Cong., 2nd Sess., p. 66.

[47] Compare I. R. C. Secs. 861(a)(1) and 862(a)(1).

[48] Compare I. R. C. Secs. 861(a)(2) and 862(a)(2).

[49] See I. R. C. Secs. 864(b)(2)(A)(ii) and 864(c)(4)(B)(ii).

business activities of foreign taxpayers which the Act makes subject to U. S. income tax is income derived from the sale outside the United States of personal property described in Section 1221(1)[50] if the sale is made through a U. S. office or fixed place of business maintained by the foreign taxpayer.[50a]

Under pre-1967 law a foreign sales corporation might establish its only office in the United States and engage in the business of selling inventory-type items. Because our source rules generally attribute the source of income from the sale of personal property to the place where the title to such property passes to the purchaser[51]—and because the arrangements for title passage frequently are within the control of buyers and sellers—the source of the income from sales by the U. S. office of the foreign corporation often may easily be arranged to constitute foreign source income of the corporation. This is possible even when the goods are sold to U. S. persons. Moreover, since many foreign countries—the United Kingdom is an important one—do not tax corporations organized in such countries if the business of such corporations is managed and controlled outside such foreign countries, and other foreign countries, for example, France, Germany, do not tax the income attributable to foreign permanent establishments of corporations otherwise domiciled for tax purposes in such countries, the country of incorporation or tax domicile of such a foreign sales corporation might not impose tax on the income derived from sales income made through the U. S. office of such foreign corporation. In addition, such sales income frequently is not taxed by the foreign countries in which the purchaser resides because the seller is not considered engaged in business in such country (or is not considered to ha' a permanent establishment in suc. country).[52] Consequently, under pr(1967 law such a sales business could be operated by a foreign corporation in the United States without paying tax to any country on the income derived from such a sales business.

As in the case of rents or royalties, under the Act a foreign sale of Section 1221(1) property by a foreign taxpayer will not be considered as made through a U. S. office or fixed place of business (and, therefore, cannot be subject to U. S. income tax) unless such office or fixed place of business actively participates in soliciting, negotiating, or performing other activities required to arrange such sale.[53] Moreover, no sales income will be considered effectively connected with the conduct by a foreign taxpayer of a U. S. trade or business if (1) the property generating such income is sold for use, consumption or disposition outside the United States, and (2) an office or other fixed place of business maintained by the foreign taxpayer outsid the United States participates mate ally in such sale.[54] Thus if a foreign order solicited, negotiated or arranged by the London sales office of a foreign corporation is filled by the New York sales office of such corporation because of a temporary inventory shortage in the London office, no U. S. tax will be imposed on such foreign source sales income of the foreign corporation because the London office

[50] Section 1221(1) of the Code refers to "stock in trade . . . or other property of a kind which would properly be included in inventory . . . if on hand at the close of the taxable year, or property held . . . primarily for sale to customers in the ordinary course of his trade or business."

[50a] I. R. C. Sec. 864(c)(4)(B)(iii).

[51] I. R. C. Sec. 861(a)(6); Reg. Sec. 1.861-7(c).

[52] Compare Reg. Sec. 1.882-2(c)(2) to the same effect.

[53] H. Rept. 1450, 89th Cong., 2nd Sess., p. 66.

[54] I. R. C. Sec. 864(c)(4)(B)(iii).

will be considered to have participated materially in the sale.

It is important to note that for purposes of determining whether a foreign office or other fixed place of business of a foreign taxpayer "participated materially" in a sale described in Section 864(b)(4)(B)(iii), non-sales activities, for example, production, purchasing, are not to be taken into account. Accordingly, under the new law the fact that a foreign office of a foreign taxpayer engages in purchasing or production activities (and no sales activities) will not affect the allocation to the U. S. office of the sales element of income generated by the purchase and sale or the production and sale of such property. Thus, for example, if a foreign corporation produces or purchases goods outside the U. S., which goods are sold to purchasers throughout the Western Hemisphere through the U. S. sales office of the foreign corporation, such production or purchasing activities of the foreign corporation will not constitute material participation in the sale. In this respect the new law does not change present law. The Code presently provides that income derived by a taxpayer from the purchase of property in one country and its sale in another country is to be allocated only to the country in which the sale is deemed to occur; [55] and that income derived from property produced by a taxpayer in one country and sold by a taxpayer in another country is to be divided solely on the basis of the production and sales activities of the taxpayer.[56] Instead, the Act simply provides that income derived from certain U. S. sales activities of foreign taxpayers may be taxed by the U. S. whether or not the technical title to the goods sold passes within the United States.

Exceptions to the U. S. Taxation of Effectively Connected Foreign Source Income. — The Act provides two specific exceptions to the U. S. taxation of foreign source effectively connected income of foreign taxpayers which income is otherwise subject to tax under the Act. Such exceptions provide that no foreign source income, even if generated by U. S. business activities of the foreign taxpayer, is to be treated as effectively connected with the conduct of a U. S. trade or business by such a taxpayer if such income consists of (1) dividends, interest or royalties paid by a foreign corporation in which the foreign taxpayer owns (within the meaning of Section 958(a) of the Code) or is considered to own (within the meaning of Section 958(b) of the Code) more than 50 per cent of the total combined voting power of all classes of stock entitled to vote; [57] or (2) Subpart F income, within the meaning of Section 952(a) of the Code.[58]

Although the exception stated in (1) in the preceding paragraph does not preclude the imposition of a U. S. income tax on foreign source sales income derived from the sale of Section 1221(1) property by the foreign taxpayer to a foreign corporation controlled by the foreign taxpayer, if such property was purchased by the foreign taxpayer, the income resulting from the sale may constitute Subpart F income; [59] and, if so, will not be treated as effectively connected with a U. S. business of the foreign taxpayer seller by reason of the Subpart F exception

[55] I. R. C. Sec. 861(a)(6) and the Regulations thereunder. Such a rule is in accord with Article 7, ¶ 5 of the OECD Draft Double Tax Convention on Income and Capital, which states that "No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise."

[56] I. R. C. Sec. 863(b)(2) and the Regulations thereunder.

[57] I. R. C. Sec. 864(c)(4)(D)(i).

[58] I. R. C. Sec. 864(c)(4)(D)(ii).

[59] I. R. C. Sec. 954(d)(1).

referred to in (2) of the preceding paragraph.

The Subpart F income exception in Section 864(c)(4)(D)(ii) prevents an overlap between the Subpart F provisions and the effectively connected provisions of the Code in respect of U. S. taxation of income of a foreign corporation engaged in business in the United States, where such income might otherwise be characterized both as Subpart F income and as income which is effectively connected with the conduct by the foreign corporation of its U. S. business. Such a dual characterization of income derived by a foreign corporation probably would not occur frequently in the absence of the specific Subpart F exception contained in Section 864(c)(4)(D)(ii). Thus, for example, because the effectively connected concept generally contemplates U. S. taxation only of income derived from the active conduct of a U. S. trade or business, any foreign source royalty income generated by a U. S. office of a foreign corporation engaged in a U. S. licensing business might be excluded from Subpart F income under Section 954(c)(3)(A), which relates to rents and royalties derived in the active conduct of a trade or business and received from other than a related person.

A similar exclusion from Subpart F income characterization would exist in the case of dividends, interest and gain on securities transactions derived by a U. S. office of a foreign corporation which is engaged in the active conduct of a banking, financing or similar business.[60] Accordingly, even without the specific Subpart F exception in the Act, in each of such cases, such income generally only would be considered effectively connected with the foreign taxpayer's U. S. business under Section 864(c)(4).

Nevertheless, the Subpart F exception in the Act governs those cases in which the Subpart F provisions and the effectively connected provision might overlap. Thus where the U. S office of a foreign corporation derives foreign source sales income from the sale of Section 1221(1) property purchased by that foreign corporation from a related person, the sales income in such a case might be both Subpart F income and income which is effectively connected with the U. S. selling activities of the foreign corporation.[61] Where such dual characterization exists, the Act has the effect of characterizing such income as Subpart F income (and excluding such income from being considered as effectively connected income) of a foreign corporation if the income is from foreign sources, and characterizing such income as effectively connected income (and excluding such income from being considered Subpart F income) of the foreign corporation where the income is from U. S. sources.[62]

With respect to the interrelationship between Subpart F income and effectively connected income of a foreign corporation, the House Ways and Means Committee Report [63] states that income of a controlled foreign corporation will not be considered Subpart F income for purposes of Section 864(c)(4)(D)(ii) "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." [63a] Thus, foreign source income can be considered effectively connected with a U. S. office of a foreign taxpayer if such income is excluded from Subpart F characterization

[60] I. R. C. Sec. 954(c)(3)(B).

[61] See I. R. C. Secs. 864(c)(4)(B)(iii) and 954(d)(1).

[62] I. R. C. Sec. 864(c)(4)(D)(ii); H. Rept. 1450, 89th Cong., 2nd Sess., p. 68.

[63] I. R. C. Sec. 864(c)(4)(D)(ii); H. Rept. 1450, 89th Cong., 2nd Sess., p. 68.

[63a] I. R. C. Sec. 864(c)(4)(D)(ii); H. Rept. 1450, 89th Cong., 2nd Sess., p. 68.

by Section 954(b)(3), the so-called 30 per cent rule, but foreign source income cannot be considered effectively connected with a U. S. office of a foreign taxpayer if such income is governed by the election provided in Section 963, relating to the receipt of minimum distributions, or by the provisions of Sections 970-972, relating to export trade corporations.

The House Report also states that "income of a controlled foreign corporation may be Subpart F income even though such income is not includible in the income of a U. S. shareholder under Section 951 because of the ownership of shares in such corporation by foreign shareholders." Thus, where a controlled foreign corporation has minority foreign shareholders, foreign source income of such a foreign corporation attributable to such minority foreign shareholder interests, which ordinarily might be characterized both as Subpart F income and as effectively connected income of the controlled foreign corporation, will not be subject to U. S. tax in the hands of the foreign corporation as effectively connected income because of the Subpart F exclusion in Section 864(c)(4)(D), even though such income also is exempt from immediate U. S. taxation as Subpart F income because it is attributable to foreign ownership of the controlled foreign corporation.

Income from U. S. Life Insurance Business.—The Act continues existing law [64] by taxing foreign source income of a foreign corporation carrying on a U. S. life insurance business if such foreign source income is attributable to the U. S. business.[65]

Senate Amendments to the Effectively Connected Concept

All of the rules discussed above were included in the House of Representatives version of H. R. 13103. Although the Senate agreed in principle with the rules described above, it added three amendments to clarify further the effectively connected concept where its effect is to impose U. S. income tax on certain foreign source income generated by U. S. business activities of foreign taxpayers.

The first Senate amendment provided that in determining whether a foreign taxpayer has an office or other fixed place of business, the office or fixed place of business of an agent shall be disregarded unless the agent (1) has the authority to negotiate and conclude contracts in the name of the foreign taxpayer and regularly exercises that authority, or has a stock of merchandise from which he regularly fills orders on behalf of the foreign taxpayer, and (2) is not a general commission agent, broker or other agent of independent status acting in the ordinary course of his business.[66] This provision is similar to the provision found in many of our income tax conventions concerning when an agent constitutes a "permanent establishment," [67] and differs from the similar OECD model provision primarily by providing that the regular filling of orders from a stock of goods maintained by an agent constitutes an office or other fixed place of business. In addition, the OECD model income tax convention and many of the tax treaties to which the United States is a party treat as a permanent establishment any agent exercising such authority—whether or not such agent

[64] I. R. C. Sec. 819(a), prior to its amendment by the Foreign Investors Tax Act of 1966.

[65] I. R. C. Sec. 842.

[66] I. R. C. Sec. 864(c)(5)(A).

[67] See, for example, Article II(1)(c)(dd) and (ee) of the Income Tax Convention between the Federal Republic of Germany and the United States, as amended by the Protocol ratified on December 27, 1965, CCH TAX TREATIES ¶ 3005.

has an office or other fixed place of business. In contrast, under the Act an agent must have a U. S. office if his principal, that is, a foreign taxpayer, is to have a U. S. office or other fixed place of business attributed to him for U. S. tax purposes under Section 864(c)(5)(A) of the Code.

It should be noted that the determination whether a foreign taxpayer has "an office or other fixed place of business" under Section 864(c)(4)(B) is important not only for purposes of determining whether the United States may impose an income tax on the specified kinds of foreign source income of the taxpayer, but also is relevant in determining whether there is a foreign office of the foreign taxpayer which materially participates in generating foreign source sales income derived at least in part by U. S. business activities of such a taxpayer.[68]

Second, the Senate added the proviso that foreign source income generated by the U. S. business activities of a foreign taxpayer should never be considered effectively connected (and, therefore, should not be subject to U. S. income tax) unless the U. S. office or fixed place of business of the foreign taxpayer is a "material factor" in the production of such income and is derived from activities regularly carried on by the U. S. office.[69] This "material factor" requirement is designed to assure U. S. taxation of foreign source income generated by U. S. business activities of foreign taxpayers only when the U. S. office is an essential and significant economic element, not just an incidental factor, in the production of such income.[70] The requirement that the income-producing activities of the U. S. office be regularly carried on by such office is intended to preclude U. S. taxation of foreign source income derived from occasional activities of the office, which occasional activities are not the ***raison d'etre*** of the office.

Thus, for example, assume that f prestige purposes a U. S. office i listed on a foreign corporation's letter head but that the U. S. office engages exclusively in purchasing activities. If a foreign customer's order unexpectedly is received and filled by the U. S. purchasing office, none of the foreign source sales income derived from such a sale would be subject to U. S. income tax because the U. S. office does not regularly conduct sales activities. In such a case, moreover, the foreign source sales income would not be subject to U. S. income tax under the Act for another reason. The test under the new law for taxing certain foreign source sales income of foreign taxpayers contemplates the active conduct of a sales business, and such a test would not be met simply because the letterhead of a foreign corporation includes the U. S. office of the foreign corporation. Thus a foreign office maintained by the taxpayer would be viewed as having "participated materially" in the sale since the U. S. office does not hold itself out to poter tial customers as the place to whi sales orders should be sent;[70a] and, in such case, such sales income would not be considered effectively connected with the foreign taxpayer's U. S. business, that is, the property sold was for use, disposition or consumption abroad and a foreign office solicited, negotiated or arranged for such sale.[71]

Neither the House version of the Act nor the House Ways and Means Committee Report contained any clear statement regarding the allocation of

[68] See I. R. C. Secs. 864(c)(5)(A) and 864(c)(4)(B)(iii).

[69] I. R. C. Sec. 864(c)(5)(B).

[70] S. Rept. 1707, 89th Cong., 2nd Sess., p. 21

[70a] H. Rept. 1450, 89th Cong., 2nd Sess., p. 66.

[71] I. R. C. Sec. 864(c)(4)(B)(iii).

foreign source income of foreign taxpayers subject to U. S. income tax under the Act between the U. S. office and another office of the taxpayer. In an attempt to clarify this allocation estion, the third Senate amendment rovided that only the foreign source ıcome otherwise subject to U. S. income tax under the new law which is "properly allocable" to a U. S. office or fixed place of business of a foreign taxpayer should be subject to U. S. income tax.[72] It is important to note that such allocation questions do not differ significantly from the allocation questions which have been required under U. S. law in the past in the case of U. S. source income attributable to a U. S. office of a foreign taxpayer.[73]

Therefore the computation of foreign source taxable income of foreign taxpayers under the new law, in general, should not require substantially different results. For example, in the case of foreign source dividends, interest and royalty income subject to tax under the Act, it may be appropriate to include the total amount of such income in the foreign taxpayer's gross income and to permit the expenses of the U. S. office, plus an appropriate portion of expenses not directly allo- ble to the income taxed to the U. S. ice, to be deducted in computing the foreign source taxable income of the foreign taxpayer. In the case of goods manufactured in one country and sold in another country, an appropriate method of computing the foreign source taxable income of the U. S. office of a foreign taxpayer would be to treat the U. S. office as if it were a separate taxable entity purchasing the goods from the manufacturing branch of the foreign taxpayer at an arm's length price.

It is important to remember, however, that the rules proposed under Section 482 for determining the proper allocation of income between related taxpayers apply specifically to two or more separate taxable entities, whereas the new law applies to separate branches or offices of a single taxable entity. Therefore, if these rules are to be applied to determine the taxable income of U. S. branches of foreign taxpayers, they will have to be modified to take into account the differences between branches and subsidiary corporations. Accordingly, the "property allocable" standard added by the Senate provides the statutory flexibility desirable to permit elucidation of these allocation problems in regulations.

Some General Observations— Section 864(c)(4) and (5)

The provisions of Section 864 which make certain foreign source income generated by U. S. business activities of foreign taxpayers subject to U. S. income tax is in accord with internationally accepted principles for the taxation of foreign investment.[74] The internal laws of many foreign countries do not contain the detailed rules which U. S. law contains for the determination of the source of income derived by taxpayers. In the absence of such detailed rules, some foreign countries utilize quite different concepts than does present U. S. law for purposes of imposing tax on foreigners doing business in such countries. Thus, as is evidenced by the language of the OECD model income tax convention, Western European countries, for example, the United Kingdom, France, the Netherlands, Switzerland and Germany, presently tax income of foreign taxpayers (including the three kinds of foreign source income which the Act taxes to foreigners engaged in business in the United

[72] I. R. C. Sec. 864(c)(5)(C).

[73] I. R. C. Sec. 861(b) and the Regulations thereunder.

[74] Footnote 4 and the text to which it relates.

States through an office or other fixed place of business) which is attributable to a permanent establishment maintained in such countries.

In Germany, the law contains source rules very similar to ours but German law provides that any income attributable to a German permanent establishment maintained by a foreign taxpayer is considered to have its source in Germany.[74a] In certain other countries—for example, the United Kingdom, France—such income is taxed without regard to the technical source of income. In other foreign countries—for example, Brazil—rules similar to our source rules are very broadly interpreted and, accordingly, the kind of foreign source income which the Act taxes—income attributable to a Brazilian permanent establishment—considered as having its source within such foreign countries.[75]

Moreover, the Act contains a provision allowing an appropriate foreign tax credit to foreigners on the foreign source income which the bill taxes.[76] The allowance of such a credit is a more equitable method of taxing foreign persons doing business in the Unitied States than is accorded U. S. taxpayers doing business in certain major foreign countries. For example, under substantially similar circumstances, the United Kingdom and Germany impose tax on foreign source income of U. S. taxpayers engaged in business in those countries, but do not allow such U. S. taxpayers a foreign tax credit for the income taxes of third countries imposed on the same income which is taxed by the United Kingdom or Germany.[77]

Accordingly, the provisions taxing certain foreign source income generated by U. S. business activities of foreign taxpayers contained in the Act simply extend U. S. jurisdiction to impose an income tax in a manner consistent with the laws of many major foreign countries. Moreover, because only three limited categories of foreign source income will be taxed under the Act, and because of the allowance of a foreign tax credit by the United States for the three limited categories of foreign source income which are taxed under the Act, the new provisions comprise a more liberal method of taxing such income than frequently exists in many major foreign countries which tax foreign source income of U. S. taxpayers doing business in such countries.

Withholding of Tax

The Act also alters the rules of U. S. taxation applicable to the withholding of tax on foreign persons.

Under prior law, a U. S. withholding tax was imposed on specified items of U. S. source income of all nonresident alien individuals, without regard to whether such persons were

[74a] See footnote 77 below.

[75] See Article 141 of the Brazilian tax regulations.

[76] I. R. C. Sec. 906.

[77] No credit for foreign taxes paid in respect of foreign source income derived by a United Kingdom branch of a U. S. corporation may be taken against such branch's U. K. corporation tax liability on such foreign source income since the foreign tax credit is allowable only to so-called resident U. K. companies (see footnote 86, below) under the provisions of Part XII of the Income Tax Act of 1952, which is made applicable to the U. K. Finance Act of 1965 by Section 64(1) of the latter Act. Relief from double taxation in the United Kingdom is thus limited to the deductibility of such foreign taxes for U. S. tax purposes. See Section 54(7) of the U. K. Finance Act of 1965, BRITISH TAX GUIDE 4-1102.

In Germany neither a credit nor a deduction is allowed with respect to third country taxes imposed on profits of a German branch of a U. S. corporation, which profits are also taxed in Germany. See, Harvard Law School WTS: *Taxation in Federal Republic of Germany*, Commerce Clearing House, Inc., Chicago, p. 564 (1963).

engaged in business in the United States; and, in the case of foreign corporations, prior law required a withholding tax on specified items of U. S. source income only in the case of foreign corporations not engaged in business in the United States. The Act conforms the withholding rules of U. S. law applicable to foreign persons by amending Sections 1441 and 1442 to provide, in effect, that no U. S. withholding tax shall be required in the case of any item of income (other than compensation for personal services) effectively connected with the conduct of a U. S. trade or business.

Moreover, the new law also changes the present withholding rules in Sections 1441 and 1442 by (1) providing for the withholding of tax with respect to certain gains to which Section 1232 applies (original issue discount)[78] and certain gains described in Section 871(a)(1)(D) from the sale or exchange of intangible property to the extent such gains are contingent on the productivity of the property sold or exchanged,[79] (2) providing the Treasury with discretion to promulgate Regulations exempting foreign taxpayers from withholding of tax at rate of 30 per cent in respect of compensation for personal services (prior law had delegated such discretion only in respect of nonresident alien individuals who enter and leave the U. S. at frequent intervals and certain so-called F and J nonimmigrants—scholarship and fellowship recipients),[80] (3) exempting from withholding under Section 1441 the interest portion of certain annuity payments described in new Section 871(f),[81] and (4) exempting from withholding under Sections 1441 and 1442 certain foreign partnerships and corporations with respect to which the Treasury determines that withholding of tax will impose an undue administrative burden and that failure to withhold will not jeopardize the collection of tax.[82]

It should be noted that the Act requires that the new withholding provisions shall apply with respect to payments made in taxable years of recipients beginning after December 31, 1966.[83] This rule was considered more desirable than a rule which applied the new withholding provisions simply with respect to payments made after December 31, 1966, because the "effectively connected" concept, to which the withholding provisions apply, is itself applicable only with respect to taxable years beginning after December 31, 1966.[84] Accordingly, in the case of a foreign taxpayer with a fiscal year beginning July 1, a withholding rule would be meaningless between January 1 and June 30, 1967, which was applicable to payments made after December 31, 1966, and which exempts from withholding tax income which is effectively connected. This is because under the Act such a taxpayer could not derive any effectively connected income until after July 1, 1967, that is, his first taxable year beginning after December 31, 1966.

Foreign Tax Credit

Under pre-1967 law foreign persons were not allowed a foreign tax credit against their U. S. income tax liability.[85] This was because such taxpayers were taxable only on income from U. S. sources.

[78] I. R. C. Sec. 871(a)(1)(C).

[79] I. R. C. Secs. 871(a)(1)(D), 1441(b) and 1442.

[80] I. R. C. Sec. 1441(c)(4).

[81] I. R. C. Sec. 1441(c)(7).

[82] I. R. C. Secs. 1441(d) and 1442(b).

[83] See Secs. 103(n)(2) and 104(n) of the Foreign Investors Tax Act of 1966.

[84] See Sec. 103(n)(1) of the Foreign Investors Tax Act of 1966.

[85] I. R. C. Secs. 901(b) and 904(a).

As previously indicated, the Act provides for the first time for the taxation of three limited categories of foreign source income generated by U. S. business activities of foreign persons if such income is effectively connected with the conduct of a U. S. trade or business. The country of the source of such effectively connected income, or the country in which the foreign taxpayer is domiciled for tax purposes, also may impose a tax on such income. Consequently, the Act provides in new Section 906(a) that for U. S. income tax purposes a foreign tax credit is to be allowed in respect of any creditable foreign income taxes paid by foreign persons and imposed with respect to income which (1) is considered to be foreign source income under U. S. law, and (2) is taxed by the United States as income effectively connected with the conduct by the foreign taxpayer of a U. S. trade or business.

However, new Section 906(b) of the Code provides that no foreign tax credit under Section 906(a) shall be allowed on U. S. source income of a foreign taxpayer with respect to otherwise creditable foreign taxes paid to a foreign country which in effect taxes the worldwide income of such foreign taxpayer. Thus assume that a corporation organized in the United Kingdom and managed and controlled in the United Kingdom [86] is engaged in a licensing business through an office located in the United States; that the U. S. office of such a U. K. corporation actively participates in soliciting and negotiating the license of a patent developed by the U. K. corporation to a Brazilian corporation; that the Brazilian corporation uses such a patent in the United States in connection with its U. S. manufacturing business; and that under Brazilian law the source of royalty income is considered to be the country in which the corporate payer of such income is organized. Under new Section 9 of the Code, any tax paid by th U. K. corporation in respect of it royalty income to Brazil would be creditable under Section 906(a)—subject to the limitations contained in Section 904—even though such royalty income is from U. S. sources and is effectively connected with the U. S. business conducted through a U. S. office of the U. K. corporation. This is because such a foreign tax is not payable solely because the U. K. corporation is created or organized under the laws of Brazil, or domiciled for tax purposes in Brazil. However, any U. K. tax payable in respect of such royalty income by the U. K. corporation would not be creditable against the U. S. tax imposed on such U. S. source, effectively connected royalty income of the U. K. corporation by reason of Section 906(b)—such a tax would be considered to be imposed solely because the U. K. corporation is domiciled in the United Kingdom for tax purposes.

Section 906(b) of the Act mak a Section 906(a) credit available foreign taxpayers in many cases in which such a credit would not have been permitted under the House version of Section 906(b). Under the House version of the bill, the limitation contained in Section 906(b) would have been applied without regard to whether the source of the income taxed to the foreign taxpayer under the Act was from United States or from foreign sources. Thus, in effect, the House provision disallowed

[86] Under the laws of the United Kingdom, a corporation is subject to U. K. income tax on its worldwide income if the United Kingdom is considered to be the place where the corporation's "central control and management actually abide," without regard to where such corporation is created or organized. See, Harvard Law School WTS: *United Kingdom,* Commerce Clearing House, Inc., Chicago, p. 124 (1957).

a foreign tax credit to a foreign taxpayer in respect of foreign taxes imposed by the foreign country which taxes the worldwide income of such foreign taxpayer, that is, the foreign untry in which the taxpayer is domi-led for tax purposes, in respect of in-ome from all sources which is effectively connected with a foreign taxpayer's U. S. business. The policy underlying the House version of the Section 906(b) limitation was that the application of the foreign tax credit provisions should adhere to the following priorities: First, the country which the Code source rules designate as the source of the income; second, the country in which the foreign taxpayer maintains a permanent establishment to which income is attributable; and third, the country in which the foreign taxpayer is domiciled for tax purposes. In connection with the change made to Section 906(b) by the Senate, the Senate Finance Committee Report on the Act states,

"In view of the fact that one of the primary reasons the foreign source income effectively connected concept is being adopted is to prevent the United States from being availed of as a 'tax haven' it is the opinion of your mmittee that the United States uld not assert tax jurisdiction in a manner which might lead to double taxation to the extent that the countries of source or residence subject the income to their tax. Therefore, your Committee concluded that the policy preventing the United States from being availed of as a 'tax haven' would not be frustrated by providing a foreign tax credit for all foreign income tax assessed with respect to effectively connected foreign source income." [87]

Would

Effect of Income Tax Treaties

THIS NOT AFFECT FOREIGN HOLDERS OF BDS IN TAX TREATY COUNTRIES.

The public comments on the Act pointed out that many of the tax treaties to which the United States is a party contain a source limitation, that is, do not permit the imposition of a U. S. income tax on the non-U. S. source income of a resident or corporation of a foreign country which is a party to a tax treaty with the United States. Thus by imposing a tax on certain foreign source income generated by U. S. business activities of foreign taxpayers engaged in a U. S. business, the Act has the effect of taxing foreign taxpayers maintaining an office or fixed place of business in the United States differently, depending upon whether they are entitled to the benefits of a tax treaty containing such a source limitation.

While a number of income tax treaties to which the United States is a party would bar the imposition of a U. S. income tax on any non-U. S. source income of foreign persons of such foreign countries,[88] the Treasury contemplates renegotiating those treaties to permit the U. S. to tax non-U. S. source income generated by U. S. business activities of foreign taxpayers in the types of cases covered by the Act. Moreover, many foreign taxpayers maintaining branches in the United States are residents or corporations of foreign countries with which the United States has no tax treaty, for example, Panama and the Bahamas, or in foreign countries with which we have tax treaties which do

[87] S. Rept. 1707, 89th Cong., 2nd Sess., p. 44.

[88] The United States presently is a party to 22 income tax conventions. Of these, nine conventions presently permit the United States to tax all industrial or commercial profits attributable to a permanent establishment maintained in the United States by a resident or corporation of the other country without regard to the technical source of such income. Such conventions presently are in force with Belgium Canada, France, Germany, Luxembourg, the Netherlands, South Africa, Sweden and the United Kingdom.

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not contain a "U. S. source" limitation, for example, Germany, the United Kingdom, France, the Netherlands, Belgium, Canada, South Africa and Sweden.

Furthermore, it did not appear advisable to defer desirable domestic legislation until the United States could renegotiate all of the tax treaties to which it is a party which contain a source limitation. To do so would have the effect of giving foreign countries a kind of veto power over U. S. internal law and, in effect, would result in conferring treaty benefits on foreign persons from countries with which the United States has no tax treaty. For example, there would seem to be no cogent reason why a "tax haven" company from Panama which otherwise mee the tests contained in new Sectio 864(c)(4)(B) of the Code should nc be taxed in the United States on foreign source income generated by its U. S. business activities merely because a treaty prevents the United States from taxing an Australian company under similar circumstances.

[The End]

From the Prospectus for the Twenty-Five Year Bonds of 1967, due April 1, 1992

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Tax Status

The Bonds and the interest thereon will not be exempt from taxation generally.

Under the Articles, the Bonds and the interest thereon are not subject to any tax (a) which discriminates against the Bonds solely because they are issued by the Bank, or (b) the sole jurisdictional basis for which is the place or currency in which the Bonds are issued, made payable or paid, or the location of any office or place of business maintained by the Bank. Also, under the Articles, the Bank is not under any obligation to withhold or pay any tax on the interest on the Bonds.

As regards United States taxation, the United States Treasury Department has ruled that interest on bonds issued by the Bank is exempt from United States income taxes, including withholding taxes, if paid to an individual who is not a national or resident of the United States, or to a corporation organized under the laws of a country other than the United States, whether or not such corporation is engaged in trade or business in the United States, unless the corporation is a life insurance company and the interest is attributable, within the meaning of the United States Internal Revenue Code, to the company's insurance business in the United States. That ruling was issued prior to the enactment by the United States of the Foreign Investors Tax Act of 1966 and is affected by that Act in the case of a nonresident alien individual, or foreign corporation, having an office or other fixed place of business within the United States. Under that Act, in the case of such persons, such interest when derived in the active conduct of a banking, financing or similar business within the United States or when received by a corporation the principal business of which is trading in stock or securities for its own account, will, for taxable years commencing after December 31, 1966, be subject to United States income tax if such interest is attributable to such office or fixed place of business and certain other conditions exist.

The Bonds are not subject to the tax on foreign securities acquired by United States persons imposed by the Interest Equalization Tax Act.

June 1966

Note: U. S. Taxes

(FOREIGN INVESTORS TAX ACT)

Under the 1966 amendments, non-resident aliens and foreign corporations engaged in U. S. trade or business would pay a normal tax on all income they received connected with that business regardless of the source of income. with certain exceptions. The fact that income on Bank bonds is not regarded as coming from a U. S. source would therefore not be relevant to the tax status of such aliens and foreign corporations. This is a change from their prior tax position.

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INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

Washington

FOR THE PRESS

Press Release No. 110

FOR RELEASE
Thursday,
August 5, 1948

The International Bank for Reconstruction and Development announced today that the United States Treasury Department has ruled that interest on the bonds of the Bank paid to foreign corporations engaged in trade or business in the United States (other than interest paid to a foreign life insurance company and attributable, under Section 201 of the Internal Revenue Code, to its life insurance business in the United States) is not subject to taxation under the Internal Revenue Code. The Treasury had previously ruled that interest on bonds of the Bank paid to non-resident aliens, or to foreign corporations not engaged in trade or business in the United States, is not subject to Federal income tax.

The latest ruling is contained in a letter dated July 21, 1948, to the Bank, a copy of which is as follows:

"TREASURY DEPARTMENT
Washington

July 21, 1948

"Mr. R. L. Garner, Vice President
International Bank for Reconstruction
and Development
Washington 25, D. C.

"My dear Mr. Garner:

"Reference is made to your letter dated April 13, 1948, requesting a ruling with respect to the question of whether interest on the bonds of the International Bank for Reconstruction and Development is subject to Federal income taxes when paid to foreign corporations engaged in trade or business in the United States.

"You refer to a ruling by the Treasury Department dated November 19, 1947, in which it was held that interest on bonds of the Bank paid to non-resident alien individuals or foreign corporations not engaged in trade or business in the United States would not be subject to taxation under sections 211(a) and 231(a) of the Internal Revenue Code, due in part to the fact that such interest could not be considered from sources within the United States under section 119(a)(1) of the Code.

"You state that the above-mentioned ruling would seem necessarily to apply equally to foreign corporations (other than insurance companies) which are engaged in trade or business in the United States in view of the provisions of section 231(c) of the Code to the effect that gross income of foreign corporations includes only income from sources within the United States.

"With respect to foreign insurance companies engaged in trade or business within the United States you further state that under your above interpretation no particular problem seems to be presented in the case of foreign mutual insurance companies taxable under section 207(a)(5) of the Code, since such section provides that net income of a foreign mutual insurance company shall be the net income defined therein from sources within the United States, nor in the case of foreign life insurance companies taxable under section 201(a)(2) of the Code since that section provides for a tax on the income of such companies attributable to domestic insurance business regardless of the domestic or foreign source of such income. You conclude, therefore, that the ruling dated November 19, 1947 would apply to mutual insurance companies taxable under section 207 (a)(5) of the Code for the same reasons given for your conclusion with respect to foreign corporations other than insurance companies engaged in trade or business within the United States, but would not apply to foreign life insurance companies taxable under section 201 (a)(2) of the Code and that income on the bonds of the Bank paid to such latter companies would be subject to tax.

"A question is raised, according to your letter, with respect to foreign insurance companies taxable under section 204(a)(2) of the Code, because of the provisions of such section to the effect that the normal tax net income and corporation surtax net income of foreign insurance companies taxable under such section shall be "the net income from sources within the United States" minus certain credits, while the provisions of section 206 of the Code state that the gross income of insurance companies taxed under section 201 or section 204 of the Code "shall not be determined in the manner provided in section 119", which latter section sets forth the rules for determining whether income is derived from sources within or without the United States.

"It is your contention that section 206 should not be read as providing that section 119 is inapplicable in determining whether income is or is not from sources within the United States, but rather as providing merely that section 119 is inapplicable in determining what types of income (irrespective of geographical source) should be included in gross income from sources within the United States, and under this contention it is your opinion that interest on the bonds of the above-named Bank when paid to insurance companies taxable under section 204 of the Code, will not be subject to tax under that section.

"Section 204(a)(2) of the Code, as stated in your letter, provides that the normal tax net income and the corporation surtax net income shall be the net income from sources within the United States. Gross income from such sources, however, is not limited to the six items specifically mentioned in section 119 of the Code but is broad enough to cover any income from United States sources although not specifically mentioned in that section (Helvering v. Suffolk Co., Ltd., CCA-4, 104 F. (2d) 505), and it has been held, in the case of income from the sale of property, to depend on all the factors of the transaction such as negotiations, the execution of the agreement, the location of the property and the place of payment. (G.C.M. 25131, C.B. 1947-2, p. 85).

"The provisions of section 9 of Article VII of the Bretton Woods Agreements Act, quoted in the previous ruling letter from this Department, dated November 19, 1947, and briefly stated herein, to the effect that no taxation of any kind shall be levied on any obligation or security of the Bank by whomsoever held if the sole jurisdictional basis for such taxation is the place in which it is issued or paid or the location of any office or place of business maintained by the Bank, and the provisions of section 116(c) of the Code, also stated in the previous ruling letter, render the factors of the transactions mentioned above inapplicable with respect to the payment of interest on the bonds of the Bank to insurance companies taxable under section 204 of the Code.

"It is the opinion of this Department that your conclusions as stated above and in your letter dated April 13, 1948 are correct with respect to the fact that interest on the bonds of the International Bank for Reconstruction and Development paid to foreign corporations, other than foreign life insurance companies, engaged in trade or business within the United States is not subject to taxation under the relative sections of the Internal Revenue Code.

"Very truly yours,

/s/ THOMAS J. LYNCH

Acting Secretary of the Treasury"

INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

FOR THE PRESS

FOR IMMEDIATE RELEASE

Press Release No. 69

November 25, 1947

The International Bank for Reconstruction and Development announced today that the United States Treasury Department has ruled that interest on bonds of the Bank paid to non-resident aliens, or to foreign corporations not engaged in trade or business in the United States, is not subject to Federal income tax under sections 211(a) and 231(a) of the Internal Revenue Code. The U. S. Treasury ruling stated that such interest, therefore, is not subject to withholding under sections 143 and 144 of the Internal Revenue Code.

This ruling, which had been requested by the Bank some time ago, was communicated to the Bank in a letter from the Acting Secretary of the Treasury.

Text of the letter follows:

"OFFICE OF
THE SECRETARY

TREASURY DEPARTMENT

Washington 25

November 19, 1947

Dear Mr. Garner:

"Your communication of July 1, 1947, relative to the applicability of the Federal income tax on interest paid by the International Bank for Reconstruction and Development on its bonds owned by non-resident alien individuals or foreign corporations not engaged in trade or business in the United States, has been receiving consideration in this office.

"The Bank for Reconstruction and Development is an international organization resident in the United States and is a juridical entity separate and distinct from its member Governments. The Bretton Woods Agreements Act (59 Stat. 512) authorized the President to accept membership for the United States in the Bank and provides that section 9 of Article VII of the Articles of Agreement of the Bank shall have full force and effect in the United States and its Territories and possessions upon acceptance of membership by the United States in the Bank. The President accepted membership for the United States on December 20, 1945. Section 9 of Article VII provides in part as follows:

> " '(c) No taxation of any kind shall be levied on any obligation or security issued by the Bank (including any dividend or interest thereon) by whomsoever held--
>
> '(ii) if the sole jurisdictional basis for such taxation is the place or currency in which it is issued, made payable or paid, or the location of any office or place of business maintained by the Bank.'

"Under the Federal income tax laws, non-resident alien individuals and foreign corporations not engaged in trade or business within the United States are subject to tax under sections 211 (a) and 231 (a) of the Internal Revenue Code on any amounts received as interest from sources within the United States. What constitutes interest from such sources is determined by statutory rules under section 119 (a) (1) of the Code. In general, interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise is treated as being from sources within the United States. However, interest received from a resident foreign corporation or a domestic corporation is not considered income from United States sources, in the hands of non-resident alien individuals or foreign corporations, if less than 20% of its gross income has been derived from sources within the United States, as determined under the provisions of section 119 of the Code, for the period specified therein.

"Under section 116 (c) of the Code, as amended by the International Organizations Immunities Act, approved December 29, 1945 (Public Law 291, 79th Congress) income of an international organization received from investments in the United States in stocks, bonds, or other domestic securities, owned by such organization, or from interest on deposits in banks in the United States of moneys belonging to such organization, or from any source within the United States, is excluded from gross income and exempt from Federal income tax. For application of such exemption, which is effective only with respect to taxable years beginning after December 31, 1943, section 1 of the International Organizations Immunities Act requires that an international organization be a public international organization in which the United States participates either by treaty or by Act of Congress, and which has been designated by the President through Executive Order as being entitled to enjoy the privileges, exemptions and immunities provided by that Act. On July 11, 1946, the President, in Executive Order 9751, designated the Bank as a public international organization entitled to enjoy the benefits conferred by the International Organizations Immunities Act.

"It is the opinion of this Department that Congress intended that no income tax should be imposed on the interest paid by the Bank on its bonds owned by non-resident alien individuals or by foreign corporations not engaged in trade or business in the United States. Such a result seems to be the intent and purpose of section 9 of Article VII of the Articles of

Agreement. Moreover, since the Bank will have no gross income from United States sources within the meaning of the Internal Revenue Code under section 116 (c) thereof, interest on its bonds cannot be considered from sources within the United States under section 119 (a) (1).

"It is concluded that interest on bonds of the Bank paid to non-resident alien individuals or foreign corporations not engaged in trade or business in the United States is not subject to taxation under sections 211 (a) and 231 (a) of the Internal Revenue Code, respectively, and therefore, such interest is not subject to withholding under sections 143 and 144 thereof.

Very truly yours,

(Signed) A.L.M.WIGGINS

Acting Secretary of the Treasury

Mr. R. L. Garner
Vice President, International Bank
For Reconstruction and Development
Washington 6, D. C."