

The first issue concerns the taxation of interest on U.S. Government obligations at a flat rate of 30 percent without any deduction for ordinary and necessary business expenses where these securities are held by Puerto Rican branches of Puerto Rican banks rather than by U.S. branches of such banks. If these securities were held by a U.S. branch of these banks there would be little question that these expenses would be deductible.

Under present law a Puerto Rican bank doing business in the United States is taxed on its U.S. source income, even though such U.S. source income may be earned in Puerto Rico. It is taxed at the regular corporate rates after the allowance of all applicable business expenses. Under H.R. 13103 only income which is effectively connected with the conduct of the trade or business in the United States will be taxed at the regular corporate rates after the allowance of all related business expenses.

Interest income from U.S. Government obligations earned by Puerto Rican branches will suffer a tax at 30 percent on the gross amount received without any deduction for ordinary and necessary business expenses. A gross income tax at 30 percent would be confiscatory since a Puerto Rican bank could not earn a profit after deducting all applicable expenses plus the U.S. gross income tax.

This is due to the fact that a Puerto Rican bank must borrow money from depositors in order to obtain the funds to acquire these Government securities. The net income, after deducting the interest costs of borrowed moneys plus investment department's expenses, leaves a profit margin considerably less than 30 percent of the gross amount of interest income received on these U.S. Government obligations.

Therefore, as demonstrated in the statement prepared and filed by Banco Popular de Puerto Rico, substantial losses would have resulted from these investments over the past 5 years if this bank were taxed at 30 percent on the gross interest income received through these investments. Banco Popular would have paid a tax on this income at an effective rate between about 152 and 177 percent. The same situation would also hold true for Banco de Ponce whom we are also representing in this testimony.

Furthermore, Puerto Rican banks will be treated less favorably under H.R. 13103 than most foreign banking institutions earning interest income from U.S. obligations. Many, if not most, foreign banks doing business in the United States are resident in countries having income tax treaties with the United States where the withholding rate is reduced from 30 percent to either 15, 10, 5 percent, or even zero. This fact is fully documented in the statements we have submitted.

Because of these income tax treaties, H.R. 13103 would be treating more favorably a truly foreign corporation rather than one who is only considered foreign for tax purposes by a fiction of law.

Puerto Rican banks must invest in the U.S. Government obligations because they are part of the U.S. banking community, and are faced with the same problems and conditions as domestic banking institutions. Although they are organized under the laws of Puerto Rico, they are nevertheless subject to certain U.S. banking laws.

For example, all Puerto Rican banks are insured by the Federal Deposit Insurance Corporation, which subjects them to Federal regulation on their financial operations.