

Federal regulation requires sound asset liquidity, and investments in U.S. Government obligations are customarily used to provide the required security for Federal deposits. By way of illustration, investments in U.S. Government obligations are necessary for the performance of the following activities: Acting as depositories for the U.S. Government and its Federal agencies, including the collection of Federal withholding taxes in Puerto Rico; 2, selling and redeeming U.S. savings bonds in Puerto Rico; 3, operating facilities at Army, Navy, and Air Force installations, just to name a few.

It is respectfully submitted that the U.S. source investment income of resident Puerto Rican banking corporations be treated as effectively connected with the conduct of their trade or business in the United States, even though such income is earned by a branch outside of the United States such as in Puerto Rico, so as to insure a deduction for all applicable ordinary and necessary business expenses related to earning this income.

The second issue on which I am testifying which concerns all foreign banks including the two mentioned Puerto Rican banks, and, in particular, the Hongkong & Shanghai Banking Corp., Barclay's Bank, and Bank of China, for whom we have also submitted statements on their behalf. The second issue concerns all foreign banks having U.S. branches or agencies and deals with the proposed rule that a U.S. place of business of a foreign bank is to be taxed by the United States on its foreign source dividends, interest, and gains from the sales of securities attributed thereto under the so-called effectively connected concept.

Under present law a foreign bank engaged in trade or business in the United States is taxed only on its income from sources within the United States. It is not taxed on its income derived from sources outside of the United States, regardless as to whether or not such foreign source income is attributed to its U.S. place of business.

Interest received from foreign obligors, including interest on securities issued by foreign governments, is exempt from U.S. income tax inasmuch as it is income derived from sources outside the United States.

Under H.R. 13103 foreign source interest income or dividend income will be subject to U.S. income tax if it is attributable to a U.S. office; that is, a domestic agency or branch of a foreign banking corporation.

The object of this provision is to treat the U.S. branch of a foreign banking corporation the same for tax purposes as the U.S. branch of a domestic bank.

At first appearances it may seem equitable to tax a U.S. branch of a foreign bank on its foreign source dividends, interest, and gains from the sales of securities since a U.S. branch of a domestic bank is also taxed on that same basis. However, closer investigation reveals that domestic banks enjoy certain income tax privileges which are not accorded to foreign banking institutions engaged in trade or business in the United States.

What are these privileges accorded to domestic but not foreign banks? A domestic bank may claim a deduction for an addition to a reserve for bad debts based upon a fixed formula without regard to its actual bad debt experience. The U.S. branch of a foreign bank may only claim a deduction based upon its actual bad debt experience