face this problem because they are taxed only on *net* income. Most foreign banks can avoid the problem (and defeat the original purpose of the Bill) by refraining from investing any funds in the United States other than those directly involved in the operation of their U.S. business. Puerto Rican banks, however, cannot resort to this expedient, because for reasons indicated later in this memorandum, they have no choice but to invest a substantial portion of their Puerto Rican funds in U.S. securities regardless of the tax consequences. For them the discriminatory and confiscatory aspects of the Bill are not only harsh and self-defeating; they are unconscionable as well.

4. We have considered above the effect of singling out the income from U.S. sources *not* "effectively connected" with a U.S. trade or business for taxation at 30% of the gross amount, without allowing any offset or deduction for the expense incurred in earning such income or the results of the taxpayer's U.S. business activities. We have now to consider the effect of the provisions of the Bill dealing with the taxation of income which *is* deemed "effectively connected" with the U.S. trade or business, with particular reference to the provisions of Code Sec. 864(c)(4) as added by the Bill and the resultant taxation under Sec. 882 of income from sources outside the United States.

Presumably the concept underlying these provisions is that two otherwise identical businesses conducted in the United States should bear the same tax burdens even though one of them is operated by a foreign corporation and the other by a domestic corporation; that as the domestically owned business pays a tax based on the entire net income of the business, regardless of the geographical source of its income, so also should the foreign-owned business, and that the income of the foreign corporation effectively connected with its U.S. business should therefore be taxed in the same manner as the income of a domestic corporation, regardless of whether the income is derived from sources inside or outside the United States.

The difficulty is that however reasonable this concept may seem in the abstract, the Bill fails to implement it with any degree of consistency. The resultant mixture of mutually contradictory concepts could not help but give rise to extreme hardship and gross inequity in many cases and so defeat the objectives the Bill was intended to achieve.

(a) In the first place, there is a basic conflict between the concepts underlying Secs. 881 and 882 as revised by the Bill. If the determinative factor in deciding whether income is to be taxed in the United States is not the geographical source of the income but the fact that such income is "effectively connected" with the business conducted within the United States, then it would seem to follow that if such income can be shown to be effectively connected with the conduct of a trade or business *outside* the United States, such income should *not* be taxed in the United States. Yet the Bill, in dealing with interest and the other classes of income covered by Code Sec. 881, not only retains the old concept of the geographical source of the income as the determinative factor but enlarges the scope of the section so as to impose the burdens of a 30% gross income tax on resident foreign corporations which have heretofore been taxed only on their *net* income from U.S. sources even when the income can be readily shown to be effectively connected with the conduct of the taxpayer's trade or business outside the United States.

(b) In the second place, perhaps in an effort to deal with some of the untoward consequences of this conflict, the Bill's proposed Code Sec. 864(c)(4)(A) and (B) limits the extent to which income from outside sources is to be deemed "effectively connected" with a U.S. trade or business (and hence taxable here) to only the three specific classes described in clauses (i), (ii) and (iii) of Sec. 864(c)(4)(B), thereby creating yet another basis for discriminatory tax treatment between otherwise comparable taxpayers. The merits of clauses (i) and (iii) are not germane to this discussion, but clause (ii) relates specifically to interest, dividends and certain capital gains income from sources *outside* the United States that are to be deemed effectively connected with the U.S. trade or business and therefore taxable under Sec. 882. As to these types of income, therefore, the Bill carries water on both shoulders, taxing interest from U.S. sources under Code Sec. 881 as revised if not effectively connected with the U.S. business and taxing interest from non-U.S. sources as well as from U.S. sources under Code Sec. 882 if it is so connected. Furthermore, to make matters worse, it does so only in the case of certain specific types of business, one of which is the banking business.

It is not apparent from the Ways and Means Committee Report why *banks* were singled out along with the very limited group of other taxpayers specified