

countries with whom the United States has an income tax treaty containing a provision reducing the rate of withholding to 15 per cent or less. For example, Article VII of the United Kingdom Income Tax Treaty exempts interest from any withholding tax, as do many of the income tax conventions concluded by the United States with other foreign countries. Article VI of the Japanese Income Tax Treaty imposes a tax of only 10 per cent on interest income derived from sources within the United States, and Article VII of the Swiss Treaty reduces such withholding rate to 5 per cent. The French and Belgium Income Tax Treaties impose a 15 per cent tax on U.S. source interest income as provided in Article 6A and Article VIII A respectively. Even though a foreign banking institution may be engaged in trade or business in the United States through a permanent establishment, if the interest income is not effectively connected with the conduct of a trade or business within the United States, then the reduced rate of tax or exemption from tax under the treaty, applicable where there is no permanent establishment, shall be applicable in such case. (Section 5(a) of H.R. 13103 amending Section 894 of the Code). This means that a foreign banking institution resident in a treaty country would only be subject to a maximum withholding tax of 15 per cent, and frequently exempt, in lieu of the 30 per cent rate applicable to Puerto Rican banks. Because of these treaty provisions, the United States is inadvertently treating more favorably a truly foreign corporation rather than one who is only considered foreign for tax purposes by a fiction of law. Politically a Puerto Rican bank is a U.S. entity and one against which the U.S. has not discriminated but has generally sought to help as other U.S. banks. Therefore, it would seem that Puerto Rican banking institutions should not be treated less favorably than banking institutions located in foreign countries.

Because of the close political and economic ties with the United States, Puerto Rican banking institutions are faced with the same problems and conditions as domestic U.S. 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 banks in Puerto Rico are insured by the Federal Deposit Insurance Corporation. This means that the taxpayer's overall operation is subject to Federal regulation. Such regulation requires sound asset liquidity, and, specifically, investments in U.S. obligations to provide the required security for Federal deposits (6 U.S.C. § 15). Moreover, Puerto Rican banks are approved depositories for the U.S. Government, and a good many of the Federal Agencies carry accounts in Puerto Rican banks, such as the well-known Tax and Loan Account of the U.S. Treasury. Puerto Rican banks also sell and redeem U.S. Savings Bonds, and operate branches and facilities at various Army, Navy, and Air Force installations in Puerto Rico. As a result of these activities, and also following generally accepted and required banking principles, Puerto Rican banks carry a secondary reserve for their total deposits in Puerto Rico, consisting chiefly of bonds and notes of the U.S. Government and its agencies. Thus, the penalty it must pay for complying with U.S. bank rules and sound American banking practice as to asset liquidity, is a tax penalty which is confiscatory and unrelated to the realities of the banking business. If interest income from U.S. obligations were earned by one of the New York branches of the bank, there would be no question that the cost of borrowing the funds to purchase these obligations would be deductible as well as other investment overhead expenses. The mere fact that interest income from U.S. Government securities is earned by a Puerto Rican operating branch rather than a U.S. branch of the bank does not provide a sufficient basis in logic and reason for distinction. In either case, the taxpayer is operating a banking business requiring the incurrence of the above expenses to earn such income, regardless of whether or not such taxable U.S. source of income is effectively connected with the conduct of the trade or business by the New York branches.

There are a number of ways in which H.R. 13103 can be amended so as to avoid this problem and, in addition, further the objectives of this legislation. Several of them are outlined below and are submitted for your consideration:

1. Permit a resident foreign banking corporation, or a Puerto Rican banking corporation in particular, to elect to treat U.S. source investment income, or income from U.S. obligations, as effectively connected with the conduct of the trade or business in the United States. By so doing, a deduction could be claimed for these expenses which are connected with earning such income, and an allocable share of those expenses which are attributable to earning such