3. The second alternative suggestion could be restricted exclusively to interest from obligations of the United States Government or its agencies.

Puerto Rico is a Commonwealth by act of Congress and is subject to Federal legislation that applies to all the States of the Union. The relations between Puerto Rico and the United States are completely different and unique when compared to those of a foreign country with the United States. Puerto Rico is part of the United States, using the same currency, same postal service, under the same customs regulations, etc. The economic ties between the United States mainland and Puerto Rico are closely interrelated by all the Federal agencies which have jurisdiction in Puerto Rico, such as the Armed Forces, the Federal Bureau of Investigation, the Federal Housing Administration, the Department of Agriculture, the Department of Commerce, the Federal Aviation Agency, the Department of the Interior, the Department of Labor, the Treasury Department, and many others. In Puerto Rico there is even a Federal District Court, and its decisions, as well as those of the Commonwealth Courts, can be appealed to the Court of Appeals (First Circuit) and then to the United States Supreme Court. Puerto Ricans are United States citizens and have all the rights, privileges, and duties of a U.S. mainland citizen.

It is, therefore, submitted that the position of Puerto Rican banks, such as this taxpayer, is unique and different from foreign investors. Substantial investments in United States Government obligations (currently $35,000,000) are necessitated because of the relationship of this Commonwealth to the United States in conducting its banking business as outlined above. To subject the gross income derived therefrom to a confiscatory gross income tax of 30 per cent is not only contrary to a major purpose of this Bill to encourage foreign investment in the United States, but also reflects an apparently unintended discrimination against Puerto Rican banks in relationship to mainland banking institutions. This Bill also defeats to some extent the fundamental objective of Congress in providing this Commonwealth with its separate taxation autonomy by subjecting interest income to a Federal tax on the gross amount.

TAXATION OF FOREIGN SOURCE INCOME EFFECTIVELY CONNECTED WITH THE CONDUCT OF A U.S. BANKING BUSINESS

A second provision of the Foreign Investors Tax Act for which the bank seeks amendment is Section 864(c)(4)(B)(ii). This subsection added by Section 2(d) of the Bill provides, in effect, that foreign source income will be treated as "effectively connected" with the U.S. business if the foreign entity conducts such business through an office or other fixed place of business within the United States, such income is attributable thereto, and it consists of dividends, interest or gains from the sale of stock, securities or notes derived in the conduct of a banking business.

The object of the Bill is "to provide more equitable tax treatment for foreign investment in the United States" as stated on page 1 of Report No. 1450 of the Committee on Ways and Means of the House of Representatives to accompany H.R. 13103. We submit that the taxation of foreign source interest income earned by a foreign corporation engaged in the banking business is in derogation of this purpose of the Bill as set forth below:

1. At first appearances, it may seem equitable to tax foreign banking institutions on their foreign source interest income if such income is attributable to activities of an office or place of business in the United States since a domestic bank is taxed on its world-wide income including that derived from sources outside of the United States. However, upon closer analysis, it becomes apparent that domestic banking institutions have certain Federal income tax privileges which are denied resident foreign banks. For example, a domestic bank may claim annual deductions for additions to its reserve for bad debts until the reserve equals 2.4 per cent of loans outstanding at the close of the taxable year, regardless of whether its bad debt experience indicates that any losses, in fact, did result. (Rev. Rul. 65–92, 1965–1 C.B. 112).

A resident foreign bank, on the other hand, may only claim a deduction for those bad debts actually incured, or a deduction for an addition to a reserve for bad debts based upon a reasonable expectation that a percentage of loans will default under the normal rules set forth in Section 166. If,