

based on subsequent experience, such bad debts do not materialize, the addition to the reserve must be restored to income by the resident foreign bank. Since the primary source of earning income for any bank is the loaning of funds, a resident foreign bank is at a distinct disadvantage in comparison to a domestic banking institution.

2. However, the inequitable tax treatment between domestic and foreign banks goes much further. As a general rule, where a taxpayer corporation disposes of a capital asset at a gain, such gain is taxed at the reduced rate of 25 per cent. Any losses derived from the sale or exchange of capital assets are first offset against the gains from such sales and any excess may be carried forward for a period of five years and utilized against future gains from the sale of capital assets (Section 1212(a)). Any excess of losses over gains from the sale or exchange of capital assets may not be offset against so-called ordinary income taxed at the regular corporate tax rates. In the case of a domestic bank, however, if the losses of the taxable year from sales or exchanges of bonds, debentures, notes, or certificates, or other evidences of indebtedness, issued by any corporation (including one issued by a government or political subdivision thereof), exceed the gains of the taxable year from such sales or exchanges, no such sale or exchange shall be considered a sale or exchange of a capital asset. (Section 582(c), Treas. Reg. Sec. 1.582-1(c)). This means that if the losses exceed the gains from the sale or exchange of such capital assets, a domestic bank secures the benefit of an ordinary deduction applicable against income taxed at the 48 per cent rate. A resident foreign bank may only deduct capital losses against capital gains taxed at the 25 per cent rate and any excess may only be carried forward for five years and charged against capital gains. If it does not have capital gains within such period or not sufficient gains to absorb such losses, the carryover can be lost forever. No deduction for capital losses is permitted against ordinary income.

3. A further area of inequitable treatment stems from the fact that domestic banks are allowed to deduct interest paid on deposits and other expenses incurred in earning tax-exempt interest. Interest income earned on obligations issued by any of the fifty states or their municipalities is exempt from U.S. income tax (Section 103). Section 265(2) sets forth the general rule that no deduction shall be allowed for interest on indebtedness incurred or continued to purchase or carry obligations, the interest from which is wholly exempt from Federal income tax. However, this rule does not apply to domestic banks. The provisions of Section 265(2) have no application to interest paid on indebtedness represented by deposits in banks engaged in the general banking business since such indebtedness is not considered to be "indebtedness incurred or continued to purchase or carry obligations . . ." within the meaning of Section 265. (Rev. Rul. 61-222, 1961-2 C.B. 58). Even though a domestic bank may use a portion of its deposits to purchase tax-exempt state or municipal bonds, the interest expense paid on such deposits is fully deductible without any allocation to the tax-exempt interest income. A resident foreign bank, on the other hand, is not accorded this same privilege. It may only claim a deduction for those expenses which are connected with earning taxable gross income from sources within the United States. (Section 882(c)(2), Treas. Reg. Sec. 1.882-3(b) and 1.873-1(a)(1)). Section 861(a) which defines income from sources within the United States limits this concept to "items of gross income." Municipal and state bond interest is not included in "gross income" (Section 103). Thus, to the extent that comparable interest expense on deposits and other expenses are attributable to tax-exempt bond interest income, they are not deductible by a resident foreign banking corporation, although a domestic banking institution can claim such deductions.

In the light of the foregoing we submit that to tax resident foreign banking corporations on their foreign source dividends, interest, and gains from the sale of securities does not achieve equitable tax treatment for their investments in the United States but serves to aggravate an inequity which exists under present law and would continue under the proposed legislation.

In addition, this novel concept of taxing foreign enterprises on their foreign source income is directly contrary to three-quarters of the Income Tax Treaties concluded by the United States with foreign countries which specifically limit U.S. taxation of foreign enterprises to their U.S. source income. (e.g., Australia—