

The Foreign Investors Tax Act (H.R. 13103) will depart radically from the foregoing principle inasmuch as it will tax certain income from sources without the United States if it is "effectively connected" with the conduct of a trade or business within the United States. 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. (Section 2(d) of the Bill and proposed Section 864(c)(4)(B)(ii) of the Code).

At present, the Hongkong and Shanghai Banking Corporation maintains its investment portfolio of Australian, New Zealand and Union of South Africa government bonds in New York. Since the interest is derived from sources outside the United States it is not presently taxed in the United States. These bonds are retained in New York and may be included as New York assets in setting credit limitations by the New York State banking authorities. Although the proposed legislation and Committee Report (No. 1450) are not entirely clear, it would appear that since these bonds are recorded on the books of the New York Agency in a memorandum account for control purposes only, and since they are considered to be qualifying assets by the New York State banking authorities, they might be attributable to the New York Agency. As a result, under the above stated rule, the interest derived therefrom might be treated as taxable income which is "effectively connected" with the conduct of a trade or business within the United States under the proposed amendments to Section 882 (Section 4(b) of the Bill).

In addition to foreign source interest income derived from Commonwealth investments, which is of great concern to us at the present time, the New York Agency also earns from its commercial banking function other types of interest income from foreign borrowers which, in fact, constitute the greater part of its earnings. It will be appreciated that the Agency is not permitted under New York State law to take deposits from U.S. residents, and consequently it operates entirely on foreign source funds lodged by overseas branches and by customers of those branches. Since the derivation of these funds is foreign and the banks sphere of operations is in the Far East and Middle East it follows that a large percentage of loans and other forms of advances are made by the New York Agency to foreigners. This interest, which is foreign source interest on these loans and advances, would include:

(1) Interest on dollar bills purchased, drawn on a foreigner abroad (no letter of credit involved)—this might be a bill for collection which the New York Agency purchases from the U.S. exporter. The New York Agency will advance the full face amount of the bill to the U.S. exporter and instruct the foreign branch to collect the interest from the foreign importer and remit the proceeds plus interest to the New York Agency.

(2) Interest earned by the New York Agency on overdrafts or loans made to foreigners abroad.

(3) Interest on loans to a foreign borrower in which the New York Agency participates with another bank.

(4) Interest earned by the New York Agency where it participates with the World Bank on loans in countries in which The Hongkong and Shanghai Banking Corporation has branches, such as loans for construction of dams, electrical plants, etc.

The seriousness of the impact of the proposed legislation is apparent for there is little doubt that such income would be considered to be "effectively connected" with the conduct of the U.S. banking business where: (1) the funds loaned are those of the U.S. place of business, or (2) the New York Agency or branch participates in effectuating the transaction between the exporter and importer (e.g., handles the correspondence, transmits documents, inspects documents, opens and advises letters of credit, makes payments, etc.). Furthermore, the fact that the foreign source interest income is accounted for through the New York branch or agency will be given considerable weight in determining whether the income is "effectively connected" with the conduct of a U.S. trade or business. (Section 864(c)(2) and (4)(B)).

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