

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 incurred, or a deduction for an addition to a reserve for bad debts based on a reasonable expectation that a percentage of loans will default under the normal rules set forth in Section 166. If, 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 years 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),