

THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

COMMITTEE ON TAXATION

Comments on H.R. 11297: "*Foreign Investors' Tax Act of 1965*"*Members of the Committee*

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Set forth below are the comments of the Committee on Taxation of the Association of the Bar of the City of New York on H.R. 11297.

According to the Ways and Means Committee's Summary, a principal purpose of the bill is to encourage foreign investment in the United States—thereby beneficially affecting the United States balance of payments—by removing tax barriers to such investment. The Committee believes that certain changes made under the bill will have precisely the contrary effect. For instance, the elimination of the income and estate tax exemptions relating to United States bank deposits must lead to withdrawals of substantial existing deposits from, and discourage potential deposits in, this country.

One further aspect of the bill may well serve to discourage investment in the United States. Under present law, it is possible to give fairly definite advice to a foreign corporation or partnership wishing to establish a branch in this country as to what part of its income will be treated as income from sources within the United States and subject to tax here. H.R. 11297 would abandon the use of these clearly defined "source" rules and instead subject to United States tax all income that is "effectively connected" with a United States branch operation. The "effectively connected" concept is vague and ill-defined. To the extent that the bill substitutes an unclear standard of taxability for a clear one, making it more difficult for a foreign investor to determine what United States tax he will pay, it will, in the Committee's opinion, serve to discourage investment in the United States.

Our detailed comments are submitted under six principal headings, as follows:

*Source of Income**Section 2(a). Interest*

The general effect of this provision is to extend the present exclusion of interest on bank deposits from U.S. source income to interest paid by savings and loan associations and to interest paid on amounts held by an insurance company under an agreement to pay interest thereon. However, with one minor exception described below, the present exclusion of bank deposit interest from U.S. source income as well as the proposed extension will terminate on December 31, 1970. Thus, all such interest paid or credited after December 31, 1970 will be subjected to a 30 percent withholding rate (or to any lower treaty withholding rate). It is believed that such change, even though deferred to 1970, will tend to discourage new deposits of substantial sums with U.S. banks, as well as encouraging the withdrawal of substantial deposits presently held by foreigners.

Section 2(a) of the bill adds a new subparagraph to the Code excluding from "U.S. source income" interest paid on foreign currency deposits in foreign branches of U.S. banks, a change which is necessary because of the proposed termination of the present exclusion of bank interest from U.S. source income. This provision is desirable but should be extended to cover all interest paid by foreign branches of U.S. banks. If interest on dollar deposits in foreign branches of U.S. banks is subject to U.S. withholding taxes, such branches will be non-competitive with local foreign banks. The resulting reduction in their earnings may tend to worsen the U.S. balance of payments. Should the above restriction induce the incorporation of their foreign branches by U.S. banks, the balance of payments may be further worsened by the accumulation of their earnings free of U.S. tax in such incorporated branches.