Testimony of Michael Gaffney
First Vice President, Co-Head, Global Tax, Merrill Lynch & Co.

on behalf of the

Securities Industry Association

before the

Committee on Finance
United States Senate

An Examination of U.S. Tax Policy and Its Effect on the Domestic and International Competitiveness of U.S.- Based Operations

July 15, 2003

I. INTRODUCTION.

Mr. Chairman and Members of the Committee, I am a First Vice President and the Co-Head for Global Tax at Merrill Lynch & Co., and I am appearing today on behalf of the Securities Industry Association (the "SIA").[1] The SIA thanks you for this opportunity to summarize our perspective on how U.S. tax policy affects the international competitiveness of U.S. firms. This is a challenging time for international tax policy. The choices that Congress makes in revising our international tax rules will be vitally important to the future health of the U.S. economy.

[1] The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs more than 700,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2002, the industry generated $214 billion in U.S. revenue and $285 billion in global revenues. (More information about SIA is available on its home page: www.sia.com .)

Traditionally, when policymakers debate the effects of U.S. tax policy on international competitiveness, they focus primarily on the consequences of various policy choices to industrial firms. The SIA fully supports the objective of a vibrant domestic industrial sector, and we also recognize the power of the argument that a significant portion of the revenues generated from repeal of the ETI regime should be reinvested in domestic manufacturing. Nonetheless, the financial services sector also makes significant contributions to domestic jobs and revenue and is profoundly affected by the international tax environment in which we do business. I speak before you today to advocate international tax rules that will promote a fair competitive environment for securities firms, banks and similar financial services firms and, as a result, strengthen our domestic economy.

We have a straightforward perspective on the goals of U.S. tax policies with respect to domestic and international competitiveness: our country's tax rules should not distort the outcomes of commercial competition among global firms, or across industries. As a result, we believe that U.S.-based global securities firms, banks and similar financial services firms should compete in London, Frankfurt, Tokyo and other major financial centers under a tax regime that is comparable to those under which our non-U.S. based global competitors operate in those same centers.

Similarly, we support fair rules for non-U.S. based global financial services firms doing business in the United States; we have no truck with tax protectionism. Finally, we believe that the international tax policies of the United States must be evenhanded across the different sectors of the U.S. economy, and not distort capital allocations within the U.S. economy by preferring one sector over another.

The report prepared by the Staff of the Joint Committee on Taxation for these hearings illustrates the importance of the financial services industries to our country's global competitiveness. That report concludes that, on an historical cost basis at year-end 2000, U.S. direct investment abroad in "finance, insurance and real estate," in addition to direct investment in foreign banks, was $534.5 billion (or 42.9 percent of the total investment), while US direct investment in foreign manufacturers amounted to $344 billion (or 27.6 percent of the total investment).[2]

Why have U.S. securities firms, banks and similar financial institutions made such large direct investments in overseas markets? The answer is simple, but often overlooked: although our businesses require substantial capital, at their heart our firms are engaged in *services* businesses. Like any other services industry, we have to go to our customers to provide the services they require. In this respect, there is a fundamental difference between all services firms, on the one hand, and manufacturers, on the other: we have no uniform "product" that can be manufactured in one location and sold in many others.

To see the magnitude of the investments that U.S. financial services firms have made in providing *services* to their local customers around the world, one only needs to look at the 2002 Annual Report of any major U.S.-based multinational financial services firm. As of the end of calendar year 2002, for example, my own firm of Merrill Lynch employed over 10,000 of our 50,900 worldwide employees outside the United States, of which nearly 5,500 were in London alone.[3]

---

[2] *See* Joint Committee on Taxation, THE U.S. INTERNATIONAL TAX RULES: BACKGROUND, DATA, AND SELECTED ISSUES RELATING TO THE COMPETITIVENESS OF U.S.-BASED BUSINESS OPERATIONS, JCX-67-03, at 46 (July 3, 2003).

[3] *See* Merrill Lynch & Co., 2002 ANNUAL REPORT, at 15, 24-6 (2003).

For the same reasons that U.S.-based financial services firms have expanded abroad, they compete here in U.S. domestic markets with foreign-based financial services firms that have invested billions of dollars to tap into U.S. markets and to reach U.S. customers.

It is critical to note that the expansion of our international business has not come at the expense of U.S. jobs, because our employees outside the United States service *local* customers, not U.S. customers. To the contrary, our growth internationally has created *more* jobs in the United States to support and manage our global customer base.

Because securities firms and similar financial services businesses are engaged primarily in the delivery of sophisticated services to customers in major financial centers, we have relatively little flexibility on where we locate our international operations. Financial services firms generally are subject to local regulation, and in order to deal with customers we are required to establish a substantial presence in each such jurisdiction. More generally, because our business model is based on providing *services to customers* – whether in an advisory role or by applying capital to provide services, financial services firms effectively are required to establish a substantial local presence in order to reach any local customer base, regardless of the regulatory environment. This comparative immobility in where we site our operations means that we are particularly sensitive to the international tax rules of the United States, as well as the local tax rules in the world's principal financial centers: we cannot, for example, simply choose to move from London to the Cayman Islands and to export our "product" back to our U.K. customer base.

To be fair, it is more difficult to design appropriate tax rules for financial services firms than it is for some other services businesses, because so much of our business involves the application of capital to provide customer services. Interest income, for example, is passive

investment income when earned by an individual investor, or even by a mutual fund – but, in the hands of a securities firm or bank, interest income arising from a loan to a customer, or from a bond held in inventory for sale to customers, is active business income attributable to our core customer services of market making and financial and credit intermediation. As a result, income from capital has different economic and tax consequences depending on the context in which it is earned.

This Committee, and its counterpart in the House, worked very hard to implement this basic principle, for example, in the "active financing income" rules of subpart F. We very much appreciate the commitment of the Committee and its staff in developing workable tests under subpart F to distinguish between passive interest income, on the one hand, and active financing income, on the other.

I will now turn to specific international tax issues of particular importance to the members of the SIA. There are many provisions of general application that affect financial services firms, but the following remarks focus solely on issues that are uniquely relevant to our industry.

II. SUBPART F OF THE CODE - Active Financial Services Provision.

Congress enacted crucial but temporary reforms of the international tax rules for financial services firms in the Taxpayer Relief Act of 1997. As a result of these reforms, "active financing income" earned by foreign subsidiaries of U.S.-based financial services firms now is taxed in the same general manner as the active business income earned by foreign subsidiaries of U.S.-based industrial firms. Since 1997, Congress has renewed the active financial services provision three times. Most recently, the provision was extended for five years in the Job Creation and Worker Assistance Act of 2002 and is scheduled to expire at the end of 2006.

As Congress recognized in 1997, 1998, 1999 and again in 2002, a U.S.-based financial services firm should not be liable for U.S. tax on the active business income earned by its foreign subsidiaries until those earnings are returned to the U.S. parent. Foreign-based competitors have always enjoyed either delayed taxation of such income or total home country exemption from tax. Similarly, U.S.-based industrial firms have never been subject to the immediate tax regime of subpart F in respect of the overseas business income of their foreign subsidiaries. In order to allow financial services firms to formulate long-range business plans in a stable and appropriate business environment, we urge that the active financing income rules be made permanent as soon as possible. *This issue is the single most important international tax legislative priority of the SIA*.

III. FOREIGN TAX CREDIT PROVISIONS.

1. Interest Allocation.

To prevent double taxation, U.S. taxpayers may use foreign income taxes that they incur in their international operations as credits against their U.S. tax liabilities. This credit is, however, subject to an important ceiling, which is that a U.S. company's foreign tax credit cannot exceed what the U.S. tax would have been on the company's "foreign-source income." Unlike other countries, the U.S. today calculates foreign-source income by allocating some U.S.-only expenses — in particular, interest expense — against foreign-source income, based on simplified apportionment formulas. These mandatory apportionment formulas are intended to do "rough justice." Current law's "water's edge" apportionment formula for *interest* expense, in addition, ignores any debt and interest expense of a U.S. company's foreign subsidiaries. As a result, for many taxpayers (particularly industrial firms), current law allocates too much U.S. interest expense to reduce foreign source income for U.S. tax purposes, leaving the taxpayer unable to credit some of its foreign tax payments against its U.S. tax liability.

As an alternative to the "water's-edge" formula, some policymakers have proposed that taxpayers be required to allocate their interest expense using a "worldwide fungibility" approach. This approach in effect views each asset of a global company as debt-financed to the same extent and at the same financing rate as every other asset of the company, including for this purpose all the assets and borrowings of all domestic and foreign subsidiaries.

The worldwide apportionment formula effectively assumes that a multinational group's domestic and international businesses are similar in their capital needs, and that money is perfectly fungible across all of the group's worldwide operations. In reality, of course, these assumptions are never perfectly correct, either with respect to the leverage of different domestic and foreign operations, or the different financing rates available in the U.S. and foreign markets. Because securities firms, banks and other similar financial institutions are very highly leveraged compared to industrial firms, any differences between commercial reality and the theoretical construct of worldwide fungibility are greatly magnified in the financial services industry.

U.S.-based securities firms have adapted their operations as best as they can to the current tax regime. Some dealers, like most industrial firms, find the current rules to be unfair, because their domestic and foreign business profiles are similar, and the premise of the worldwide fungibility of money therefore reasonably describes their operations. Other firms, however, have found that worldwide fungibility would only make matters worse, because of significant differences between the kinds of businesses they conduct domestically and internationally (and therefore the leverage or financing rates applicable to each).

We frankly have not been able to construct a single interest allocation model that accurately reflects the business realities of different highly-leveraged financial institutions with different business mixes, given that money in fact is not perfectly fungible across global

businesses. Accordingly, we propose that financial services groups be permitted to elect to allocate their interest expense under the current law provisions, or alternatively to apply the "worldwide fungibility" approach, depending, in effect, on which regime more closely describes their business model. We suggest that the election be made once every five years. This would prohibit attempts to game the system, but would permit taxpayers to revise their elections as their long-term business strategies (and hence mix of business) evolve. The election should apply only to taxpayers that are *bona fide* financial services groups, which meet the qualitative and quantitative income requirements for the group as a whole to qualify as a financial services entity for foreign tax credit purposes.[4]

In addition, consideration could be given to reducing the cost of such an election, and simplifying its administration, by providing that current law's financial institution subgroup rule would *not* apply to a financial services group that elects to allocate interest expense under current law.

Finally, if worldwide fungibility is enacted for any group of taxpayers (industrial or financial), the application of those rules to intercompany debt owed by foreign subsidiaries to the U.S. parent must be addressed. It is tempting to suggest that this is the sort of technical matter best left to regulations, but in light of the amount of intercompany debt outstanding among multinational groups today, and the confusion that would result if implementing regulations either were not issued quickly or were not clear, it is imperative that a worldwide fungibility statute be clear on its face, and applied in a manner that is consistent with its purpose.

2. Permanent Difference Items.

Current law assigns a taxpayer's items of foreign income to nine different income baskets: the first eight baskets address specific categories of income, and all remaining income is

[4] Treasury Regulation section 1.904-4(e)(3)(ii).

assigned to a "residual" or "general limitation" basket. Treasury regulations then allocate the foreign taxes incurred by the taxpayer to the different income baskets to which those relate.

For a manufacturing or typical services firm, the "general limitation" basket effectively is the base case: income from core business activities falls into that basket, and only in specific (and generally exceptional) cases does income fall into other baskets. For a financial services firm, by contrast, the "financial services income" basket is intended to sweep within it all of its core business income, and the general limitation basket in fact holds only income derived from peripheral activities not connected with the firm's core financial services business.

It sometimes is the case that a foreign jurisdiction will impose tax on amounts that are not (and never will be) income in a U.S. sense; these amounts are generally described as "permanent difference items."[5] Current Treasury regulations (§1.904-6(a)(1)(iv)) arbitrarily assign foreign taxes paid on a permanent difference item to the general limitation basket.

The current rule makes sense for U.S. manufacturing firms; because the general limitation basket is the base case income basket for those companies, U.S. manufacturing companies will more likely be able to eventually credit those real foreign tax costs. This same rule penalizes financial services firms, however, because for the financial services industry only income (and taxes) from peripheral activities fall into the general limitation basket. For financial services firms, the financial services basket, not the general limitation basket, is the base case.

This problem arises as a result of many acquisitions and other commonplace transactions; accordingly, the SIA recommends that a statutory provision be adopted to recognize

---

[5] For example, if a U.S. financial services company acquires a foreign target that holds a portfolio stock investment in a third company and the acquiror makes a section 338 election, the resulting step-up in the subsidiary's tax bases in its assets will mean that the foreign subsidiary may not recognize gain on a subsequent resale of that portfolio stock investment for U.S. tax purposes, while recognizing gain (and incurring a real tax liability) under local law. The result is a permanent reduction in the subsidiary's total income from a U.S. perspective, when compared to foreign law tax accounting norms.

that the financial services income basket is the base case basket for financial services firms, and therefore to put otherwise unclassified foreign taxes on permanent difference items into this base case basket. This solution will provide financial services with the same opportunities that are already provided to industrial firms to recoup their actual foreign tax costs derived from active business activities.

3. Section 904(g) Reform.

Section 904(g) is part of the regime for determining the source of income for purposes of section 904's limitations on the utilization of foreign tax credits. Section 904(g) currently provides as a general rule that income derived by a U.S. parent company from its foreign subsidiary will be resourced from foreign-source income to U.S.-source income, to the extent that the foreign subsidiary in turn is treated as having earned that income from U.S. sources.[6]

When applied to foreign securities dealer subsidiaries of U.S. financial services firms, the resourcing rules inequitably limit the ability of U.S. securities firms to utilize U.S. tax credits for foreign taxes paid on income derived from their overseas securities dealing businesses. Foreign securities dealer subsidiaries of U.S. firms often deal in U.S. securities, such as U.S. Treasurys and U.S. issuer-Eurobonds, to serve local customer needs or as hedges of local customer contracts. Since dividends and interest payments generally are sourced for U.S. tax purposes according to the residence of the *payor* thereof, foreign securities dealer subsidiaries of U.S. firms necessarily receive U.S. source dividends and interest in the ordinary course of their

[6] Thus, for example, if a U.S. corporation earns interest income from a U.S. Treasury held as an investment, that interest income is U.S. source. Section 904(g) provides that the result is the same (*i.e.*, U.S. source income) if the U.S. parent company causes a subsidiary to buy that U.S. Treasury as an investment, and then derives interest, dividend or subpart F income from its subsidiary attributable to the earnings on that U.S. Treasury.

securities dealing businesses with *customers*, and *are subject to tax on such income* in the foreign jurisdictions in which they operate.

The policy underlying the sourcing rules of section 904(g) is to prevent the resourcing of passive and mobile income derived from U.S. sources through the use of foreign subsidiaries. This policy concern, however, is not implicated in the case of dividends and interest income received on U.S. securities held by a U.S.-owned foreign securities dealer for purposes of conducting its securities dealing businesses with foreign customers. Therefore, the SIA recommends that an amendment be made to section 904(g) to exclude from its scope income derived from a U.S.-owned foreign securities dealer subsidiary that is in turn derived from any security (as defined by section 475(c)(2), which includes physical securities and derivative instruments) held by a person in connection with its activities as a securities dealer.[7]

4. 10/50 Corporations.

The SIA endorses proposals of policymakers which would apply a look-through approach to dividends paid by so-called "10/50 corporations," regardless of the year in which the relevant earnings and profits were accumulated.

IV. SECTION 956 – INVESTMENT IN UNITED STATES PROPERTY.

Section 956 of the Code is an anti-abuse measure that treats an investment by a foreign subsidiary of a U.S. parent company in "United States property," such as stock or debt of a U.S. affiliate, as a deemed dividend for subpart F purposes, on the theory that such transactions economically are similar to a direct repatriation of the subsidiary's earnings. In this regard, Congress has recognized in the past that certain exceptions to the definition of "United States property" are warranted to cover ordinary course business transactions entered into by foreign

securities dealer affiliates of U.S. securities firms because such transactions do not violate the purpose of section 956.[8] All of the issues described below relate to continuing technical problems in the mechanical application of current section 956 to U.S. securities firms, banks and similar financial services firms, in contexts that do not implicate section 956's policy agenda.

1. Sale of U.S. Affiliate's Securities in the Ordinary Course of Business.

"United States property" generally includes stock or debt of a foreign subsidiary's U.S. parent (or any other U.S. affiliate). Currently, there is no exception to this general rule to cover the case, which commonly occurs, of a foreign securities dealer subsidiary of a U.S. financial services firm that makes a market in the securities of a U.S. affiliate. The effect of current law is to provide a disincentive for U.S. financial services firms to use their own foreign subsidiaries to make markets in securities that the U.S. group issues to international investors, which is a nonsensical result as a commercial matter.

The solution to this very frustrating problem is to exclude from the definition of United States property any security issued by a U.S. affiliate held by a foreign dealer in securities, provided that (i) such securities are held primarily for sale to customers in the ordinary course of business, and (ii) the dealer in fact disposes of such securities within a period consistent with holding such securities for sale to customers in the ordinary course of business.

---

[7] A similar amendment was proposed by section 203 of the International Tax Simplification for American Competitiveness Bill (introduced in the 105th Congress, 2d session, as H.R. 4173).

[8] The Taxpayer Relief Act of 1997 amended section 956 by adding two exceptions to cover ordinary course transactions entered into by foreign securities dealer affiliates of U.S. securities firms, *e.g.*, securities loans and sale-repurchase agreements. Under both types of transactions, collateral *equal in value* to the cash or securities loaned is required to be posted, as is the case in similar transactions with unrelated parties at arm's length. See section 956(c)(2)(J) and section 956(c)(2)(K).

2. Investments in Unrelated Non-Corporate Entities and Individuals.

Section 956(c)(2)(F) provides that United States property does not include the stock or obligation of an unrelated domestic corporation.[9] There is no parallel exception to the definition of United States property for investments made in obligations of unrelated U.S. partnerships, trusts, estates, or individuals.

As a result, section 956 today applies beyond its intended scope. It also hinders the ordinary course overseas business activities of U.S.-based financial services firms and, in addition, gives preferential treatment to offshore investment funds as compared to onshore funds, by placing barriers to domestic partnerships looking to finance purchases of foreign securities. Section 956 should be amended to provide for an exception from the definition of United States property for obligations of *unrelated* U.S. partnerships, trusts, estates and individuals, provided, of course, that those entities in turn hold no securities of a U.S. affiliate.

V. EARNINGS STRIPPING.

The earnings stripping rules of section 163(j) primarily are relevant to foreign-owned firms, because they limit the ability of foreign-based multinationals to reduce the taxable income of their U.S. subsidiaries through the payment of interest expense to foreign affiliates (or to third parties in respect of debt that is guaranteed by foreign affiliates).

Proposals have been made to significantly tighten the "earnings stripping" rules of section 163(j). If enacted, some of these proposals could have dramatic adverse consequences to the U.S. securities dealer affiliates of foreign banking institutions. As discussed previously, interest expense often represents the largest single category of tax deduction to a financial

[9] For example, a domestic corporation that "is neither a U.S. shareholder (as defined in section 951(b)) of the controlled foreign corporation, nor a domestic corporation, 25 percent or more of the total combined voting of which, immediately after the acquisition of any stock in such domestic corporation by the controlled foreign corporation, is owned, or is considered as being owned, by such United States shareholders in the aggregate;"

institution, and any distortion in the amount that the Code treats as deductible therefore can have enormous repercussions. As a result, any change to the tax rules in this area must be carefully considered and based on sound tax policy.

The SIA believes that it is vitally important that all securities firms doing business in the United States compete on a level playing field. This issue is important not simply to our member firms that ultimately are foreign-owned. U.S.-based member firms also are interested in a fair resolution to this issue, because, if the United States were to adopt rules that were perceived as a form of tax protectionism, our U.S.-based members see the possibility of foreign retaliatory "mirror" rules as a real possibility.

VI. GLOBAL DEALING OPERATIONS/DIVIDENDS-RECEIVED DEDUCTION.

Some financial services businesses, such as some derivatives or foreign currency dealer operations, typically are organized and conducted in a single globally-coordinated fashion (generally referred to as "global dealing" operations). U.S.-based financial services firms engaged in global dealing operations have faced many tax issues over the years relating to the allocation and sourcing of income and deductions among related taxpayers engaged in such operations, and the possibility of multiple layers of taxation.

Foreign subsidiaries of U.S.-based financial services firms may operate global dealing activities through branches in several countries, including the United States. As a result, these foreign subsidiaries of U.S. firms may derive income that is subject both to U.S. net income and branch taxes and to tax in their home jurisdictions. The net result can be the imposition of up to four layers of taxation (one foreign, and three U.S. layers) on the same item of income, as it is distributed back to the U.S. parent: (1) U.S. net-basis taxation of trading profits attributable to the U.S. branch of the foreign subsidiary, (2) foreign net-based taxation of the global income of the foreign subsidiary, (3) U.S. branch taxes (including the branch level tax

on “excess interest” and the tax on the “dividend equivalent amount”) and (4) U.S. taxation of dividend income when the foreign subsidiary pays an actual dividend to its U.S. parent corporation – even when the dividend is attributable to “effectively connected income” (“ECI”) and a U.S. corporate tax has been previously paid – with no credit or other relief for any foreign withholding tax paid to the foreign subsidiary’s home country.

The SIA is optimistic that in due course final Treasury regulations will develop a rational regime to reduce the instances in which the IRS asserts that a global dealing operation gives rise to an inadvertent deemed U.S. branch. In the meantime, however, we urge adoption of the following three legislative actions to prevent a U.S. securities firm engaged in a global dealing operation from suffering unintended triple taxation of income:

- Amend section 245(b) to permit a 100 percent dividends-received deduction (“DRD”) where a dividend is attributable, directly or indirectly, to earnings of a 100 percent owned foreign subsidiary that have been subject to U.S. net income tax;
- Amend the branch tax rules to provide an exception for ECI of a 100 percent owned foreign subsidiary that has been subject to U.S. net income tax; and
- Provide a direct foreign tax credit to the U.S. parent for foreign taxes payable on the portion of dividends received from a foreign subsidiary that are treated as derived from U.S. sources and are paid out of earnings previously subject to U.S. net income tax.