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SIFMA VIEWS ON TAX REFORM

On behalf of the financial services industry, SIFMA[1] engages with policymakers and regulators through comment letters, testimony, studies and more. This paper summarizes SIFMA's current views on selected tax policy issues that may come before the Senate Finance Committee as it considers how to reform the Internal Revenue Code.

APRIL 15, 2015

[1] SIFMA is the voice of the U.S. securities industry, representing the broker-dealers, banks and asset managers whose 889,000 employees provide access to the capital markets, raising over $2.4 trillion for businesses and municipalities in the U.S., serving retail clients with over $16 trillion in assets and managing more than $62 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

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Unintended Consequences of a Tax on Bank Lending (Bank Tax)

In early 2010, the Obama Administration proposed a new tax on financial institutions called the "Financial Crisis Responsibility Fee." Originally, the primary rationale was to recover the cost of the financial assistance provided to banks and other companies through the Troubled Asset Relief Program (TARP). Later, after TARP had been fully repaid, the Administration renamed the proposal the "Financial Fee" and explained that its purpose is to reduce the incentive for financial firms to undertake "excessive risk." The latest version of the tax in the Administration's FY 2016 budget would impose a new seven (7) basis point tax on the covered liabilities of financial firms, including non-banks, with more than $50 billion in worldwide consolidated assets.

SIFMA has serious concerns about these proposals. Banks already have fully repaid their TARP liabilities, and the imposition of a special, sector specific tax on financial institutions with the goal of limiting excessive risk taking is both inconsistent with the purpose of tax reform and unlikely achieve its stated objective without serious unintended consequences. A targeted tax increase on one of America's most productive private sector industries is likely to have far-reaching negative consequences that could curtail economic growth and job creation while adversely impacting the allocation of credit and the ability of our member firms to provide financial services.

A Tax on Lending - - A tax on the assets or liabilities of large financial institutions would reduce the amount of loans such institutions can make, due to long standing regulatory requirements. The true burden of the tax will fall on borrowers in the form of higher interest rates, and, although some portion will be borne by bank shareholders, many of these shareholders are retirees who hold stock through a retirement fund. It would be more accurate to describe the "bank tax" as a tax on American consumers of credit: from families buying a new car, to credit card holders, to businesses seeking to expand and create jobs.

- **Impact on Consumers - -** with less money available to lend to consumers, individuals and families seeking to buy a car for transportation to work or fund unexpected medical expenses will face tighter credit standards and higher interest rates.

- **Impact on Small Business -** - Large businesses and state governments can access capital markets directly to raise capital. Smaller businesses depend, to a much greater degree, on lending from banks. A tax on bank lending would impact these small business consumers of credit far more than other borrowers. Much like consumers, small businesses would face tighter credit standards and higher interest rates. They would be less able to fund a business expansion that would create new private sector jobs.

- **Impact on the Economy - -** With fewer businesses and consumers able to borrow, the tax on bank lending would throw sand in the gears of the American economy. Less consumer spending and less credit available to business would have a double negative impact on economic growth. Only government and the non-profit sector would remain unaffected.

Picking Tax Winners & Losers - - Congress should avoid picking winners and losers by manipulating the tax code to achieve non-tax policy objectives. One of the main objectives of tax reform is to remove such distortions to ensure that the tax code is not an obstacle to growth or a vehicle for discredited Soviet-style industrial planning. By targeting a single industry, the proposal introduces a new type of distortion that will be no less harmful in the long run.

IRS as Financial Regulatory Agency - - The Treasury Department, the Federal Reserve, and a host of independent agencies currently regulate risk taking in the financial sector. The 2010 Dodd-Frank law granted broad new powers to every one of these agencies, and created new ones to control risk taking and avoid future taxpayer bailouts. SIFMA and its member firms generally have supported these efforts and have engaged constructively at each stage of the legislative and regulatory process. We are concerned, however, that the IRS lacks the expertise necessary to make the regulatory judgments necessary to administer this new tax. Tax rules are often blunt instruments and the tax code is not the place for a broad, new, and duplicative financial regulatory regime.

SIFMA Advocacy Links

- SIFMA statement on bank tax in White House proposal, January 10, 2015
- Trade groups send letter to Chairman Camp opposing lending tax in tax reform proposal, February 26, 2015
- SIFMA statements r e gar ding President Obama's FY 2014 budget proposal dated Apr. 10, 2013
- Joint trades comment to the House Majority and Minority Leaders dated September 16, 2010

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Tax Treatment of Debt and Equity

Discussions surrounding comprehensive tax reform often include some consideration of the tax treatment of debt and equity. Over the years, several tax reform plans have incorporated proposals to limit the deductibility of business interest expense, [2]including as a means to help pay for reductions to the corporate tax rate. Some examples include -- the business tax reform framework released by the Obama Administration in early 2012, the Administration's FY2016 budget proposal to limit the net interest expense deduction of a US corporate taxpayer that is a member of a worldwide consolidated group, and the comprehensive income tax reform bill introduced by Sens. Ron Wyden (D-OR) and Dan Coats (R-IN) in the 112th Congress.

SIFMA generally opposes broad proposals to limit the deductibility of interest for business taxpayers. If such a proposal does move forward, however, it is imperative that any limitation be applied to net, rather than gross, interest expense. Specifically, net interest is the excess of interest expense in excess of interest income.

It has been a long-standing principle, dating back to the inception of the corporate income tax, that businesses are entitled to claim a deduction for their interest expense as a cost of doing business. Limiting the deductibility of interest expense would run counter to that fundamental tenet of our tax system. The consequences to businesses, their owners and employees, and the markets as a whole could be highly disruptive.

Some have argued that a limitation is necessary to address a bias in the U.S. tax system for debt over equity. However, we believe that any bias favoring debt in the current tax system is a product of many factors, and that if Congress genuinely wishes to adjust the balance of incentives for debt and equity, it should examine the rules on a far more comprehensive basis, rather than addressing only the deductibility of interest. For example, over the years Congress has chosen to exclude a significant share of interest income from the income tax base of many recipients, or to lightly tax such interest income. Meanwhile, other features of the income tax system increase the cost of equity financing as compared to debt financing, including the double taxation of corporate profits through the corporate and individual income tax systems. If Congress chooses to change the relative incentives for debt and equity, it should do so on a holistic basis, rather than simply taking a piecemeal approach to interest deductions.

Furthermore, no other developed country imposes an across-the- board limitation on the deductibility of interest. Instead, some countries have adopted more targeted approaches, including limitations on deductions by thinly capitalized companies. Moreover, these regimes, such as the German thin capitalization rules, apply a limitation only to *net* interest expense, in large part to accommodate the efficient operation of financial institutions.

[2] Net interest is the excess of interest expense in excess of interest income.

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Some critics support limitations based on gross, rather than net, interest as a means of discouraging excessive risk-taking by financial institutions. SIFMA strongly disagrees with such proposals, for two reasons:

- First, a limitation on interest deductions effectively would function as an additional regulatory capital requirement because of the immediate hit such a limitation would have on the balance sheets of financial institutions. Bank capital requirements should be set by banking regulators with the oversight of the Congressional financial services committees that are charged with such responsibility and have the unique experience and perspective necessary for making these policy judgments. Financial services companies are subject to substantial regulation, both domestically and around the globe, and these regulatory requirements have been evolving dramatically since the financial crises. These requirements, which determine the amount of capital that financial institutions are required to hold and the amount of debt they are permitted to hold and to issue, have significant impact on the global financial markets and the U.S. economy. Using the tax system to implement an additional regulatory capital requirement that is uncoordinated with the efforts of U.S. and foreign financial regulators would be disruptive and create added stress to the financial system.

- Second, while financial institutions may be highly leveraged, the amount of permissible leverage, and the cost of funds, varies substantially from activity to activity within the same enterprise. Consequently, a one-size-fits-all approach, like limiting deductions based on gross interest, would ignore the different capital needs required to support different types of lending activities, and create a misalignment of risk within financial institutions. Again, refinements to the capital and leverage requirements are better left to financial regulators, who have the necessary experience with financial firms' activities and capital needs. For example, some of the lowest-risk activities conducted by banks - -such as the so-called repo businesses that involve short-term borrowing to support similarly short-term lending operations - - are essential to a bank's proper and efficient lending operations: its core business. These transactions, some relating to Treasury securities, involve great amounts of leverage, and generate relatively low profit margins. Limiting deductions for interest expense would have counterproductive impacts, including damaging the liquidity of the Treasury market and discouraging low-risk activities that are important to the health and efficiency of the financial system, without affecting risk-taking.

For financial institutions, interest expense is the equivalent of the cost of goods sold, and imposing a limitation on gross interest expense deductibility would be akin to limiting the deduction for raw materials by a manufacturer, or labor costs for a retailer. The indiscriminate disallowance or deferral of deductions for interest expense would dramatically impact the orderly lending business operations of financial institutions.

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Taxation of Securities Transactions

Recent plans to reform the tax code have included changes to the taxation of securities transactions.

In January 2013, former House Ways & Means Committee Chairman Dave Camp (R-MI) released a discussion draft outlining significant changes to the taxation of investment securities. This bill later became H.R. 1. While we commended the Ways & Means Committee Chairman for initiating a dialogue about an area of the tax law that is in need of greater consistency and clarity, we have a number of concerns about the discussion draft. We believe some of the proposals in the discussion draft are sensible, while others, such as the proposal to expand mark-to-market taxation to all derivatives and the average basis proposal, raise significant business, policy, and administrative concerns that warrant further review by policy makers. SIFMA filed a detailed comment letter with the Committee on Ways and Means addressing some of these concerns.

On March 3, 2015 Senate Finance Committee Ranking Member Wyden (D-OR) introduced a new package of financial products-related proposals as part of a report on "How Tax Pros Make the Code Less Fair and Efficient: Several New Strategies and Solutions."

Impact on Ordinary Investors

SIFMA supports efforts by Congress to develop a more rational regime for the taxation of investment securities. Nevertheless, we have concerns that any broad proposal to mark derivatives to market will require individual retail investors to pay tax on unrealized annual appreciation in a wide array of assets at ordinary income tax rates, before the receipt of cash, and will reduce the current incentives for savings and investment. We have similar concerns about the proposal in the Administration's FY 2016 Budget to require investors to use the average basis method to measure gain, and the proposal to expand current taxation of market discount on certain bonds. The mark-to-market proposal would impact the routine investments of ordinary investors, many of whom are not at all wealthy or sophisticated, but who may have derivative exposure due to holdings in mutual fund shares, exchange traded notes (ETNs), exchange traded funds (ETFs), convertible securities, corporate bonds, listed options, stock in margin accounts, structured notes, or short positions. The securities investments affected by these proposals are:

- **Widely Held** - - More than 90 million American investors in more than 50 million households hold investments in one or more of the above asset classes;

- **Significant in Value** - - Non-business investors hold approximately $5.1 *trillion* in taxable mutual funds and ETFs according to recent survey estimates by the Investment Company Institute; and

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- **Often Held by Middle-Income Investors** - - 62% of households that own mutual funds and ETFs have income of less than $100,000. 93% have income under $200,000. Approximately 30% of the 4 billion exchange traded options trades per year are small lot trades.

With the impact on investment in mind, Congress should carefully consider the intended scope of these proposals so that they do not increase the federal tax burden of individual retail investors or disrupt U.S. capital markets. SIFMA is prepared and willing to assist members of Congress to achieve their objectives in this area.

Complications to Tax Compliance for Individual Investors

Proposals impacting the taxation of securities transactions would complicate tax compliance and increase record keeping burdens for millions of individual investors. Specific areas of concern include the valuation of non-publicly-traded derivatives; uncertainty regarding the scope of the expanded straddle rule and the definition of derivative; and record keeping and reporting associated with the current taxation of market discount and average basis proposals. We would like to better understand the rational for these proposals.

Administratively Costly

In addition to compliance burdens for individual investors, these proposals could impose significant new tax compliance burdens on the financial services industry and create difficult new administrative challenges for the IRS. The expanded straddle rule within the mark-to-market proposal would create substantial interpretive and compliance problems, which would frustrate the policy of Congress to have the financial services industry report accurate basis information. The financial services industry is currently engaged in a major effort to build systems and train personnel to comply with the requirement to report tax basis to investors. Many of these systems would need to be re-designed to comply with the Administration's average basis rule.

Unintended Consequences

SIFMA believes that there are many unintended consequences that could flow from the broad definition of derivatives in the mark-to-market proposal and are concerned that some of the uncertainties in the application of the proposal could linger without timely resolution if substantial regulatory authority is delegated to the IRS to fill gaps. We remain concerned that line drawing in this area will be inherently difficult and the end-result could be a more complicated, not a simpler, tax code.

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International Tax Reform

SIFMA is pleased to have the opportunity to submit its views on international tax reform.

The United States is one of the only remaining countries that continue to tax its residents on income derived from the active conduct of a foreign business. Most of our trading partners have moved toward a more competitive exemption or partial exemption system, under which business income earned by foreign subsidiaries is taxed primarily in the country where it is earned, and anti-base erosion regimes, usually called "CFC regimes," serve to protect the home country tax base. One of the most important issues in the current international tax reform debate is whether the United States should replace its current worldwide tax regime with a hybrid system that includes an exemption for all or most active foreign subsidiary earnings. Over the last several years, numerous legislative proposals and discussions drafts have been put forward in this regard, including The Tax Reform Act of 2014 (H.R. 1) introduced last year by then House Ways and Means Committee Chairman Dave Camp (R-MI), legislation introduced in 2012 by Sen. Michael Enzi (R-WY), a discussion draft released in 2013 by then Senate Finance Committee Chairman Max Baucus (D-MT), and proposal included in President Obama's FY 2016 budget among other proposals.

SIFMA believes that a well-crafted exemption system, with appropriate safeguards against base erosion, would be strongly beneficial to the U.S. economy. A properly designed system would (i) eliminate the "lockout" effect of current law (which can create undesirable incentives to retain earnings outside the United States rather than repatriating those earnings in the form of dividends); (ii) reduce tax disadvantages that make it more difficult for U.S. multinationals to compete effectively in foreign markets; and (iii) create opportunities for simplification by eliminating the need for some of the most complex features of the current system.

Whatever approach Congress decides to adopt for international tax reform, active foreign financial services businesses must continue to qualify for the same treatment as other active foreign businesses: a full or partial exemption for foreign earnings, if Congress decides to proceed with such a system. Therefore, assuming a Subpart F regime is retained in a reformed system, it will be necessary to include permanent rules, similar to those under the current active financing exception to Subpart F, that distinguish what would be passive income in the hands of a nonfinancial services company with active income for banks and broker dealers.

If Congress adopts a form of exemption system, it will be important to provide transition rules that preserve the ability of taxpayers to make use of existing tax attributes, and that any transition tax imposed on previously untaxed foreign earnings that provides a preferential tax rate for illiquid assets include local capital of regulated financial institutions in the definition of such assts. SIFMA believes that as a policy matter, requiring the allocation of U.S. expenses to exempt income, particularly relating to interest expense, should be achieved through a proxy tax on foreign earnings rather than through a formulary approach for allocating such expenses. In addition, if international tax reform includes a thin capitalization regime to protect against base erosion, that regime should apply to *net* interest expense (as explained further below). Tax reform should preserve the principle of the "look-thru" rules, under which the transfer of funds from one foreign subsidiary to another does not trigger tax costs for a U.S. parent company. Finally, Congress should make all of the rules permanent. Some of the most important provisions of the current system have been adopted on a time- limited basis and renewed from year to year as part of an "extenders" package.

Key Considerations for Financial Services Businesses

We are *customer-facing* businesses. Our foreign operations must be physically located where our customers are located. In this respect, we are perhaps more similar to a global restaurant chain than to businesses that can concentrate profits in a central hub. Unlike other multinational businesses, we don't have meaningful opportunities to transfer intangibles to low-tax jurisdictions, or to exploit significant transfer pricing opportunities. Instead, we need to maintain a substantial physical presence in the world's major financial centers. In order to be able to provide services to our customers, we need to be licensed and regulated in those centers.

We are *highly regulated*. We are subject to stringent regulatory capital requirements in virtually every country in which we operate. We cannot shift capital from country to country in pursuit of the most favorable tax climate.

We face *multinational and local competitors*. We compete in foreign markets with local as well as global banks and securities dealers. A U.S.-owned bank wishing to do business in China will face competition not only from German and U.K. banks but also from domestic Chinese banks. In some markets, local banks have the largest market share.

Treatment of Financial Services Income

Congress has developed carefully tailored rules for determining when foreign income derived by securities dealers, banks and other financial services businesses is sufficiently active to qualify for deferral, and thus an exemption from Subpart F. Those rules (sometimes referred to as the active financing exemption or "AFE") reflect Congress's recognition that: (i) the *businesses* conducted by financial services companies can be just as active as the businesses conducted by manufacturing, pharmaceutical or high-tech companies, but (ii) the *principles* used to distinguish active from passive income in the context of non-financial businesses don't work for financial services businesses. This is because of the residual approach described above, under which interest, dividends and gains earned by non-financial businesses generally constitute passive income.

The AFE therefore prescribes criteria for determining when income that would be considered passive in the hands of a non-financial business will be treated as active in the hands of a financial business. Congress has recognized that money is the stock in trade—the widgets, in effect — of an active financial business. The AFE rules are the most fully developed and rigorous tests applicable under Subpart F. The rules are designed to ensure that income is earned in the active conduct of a financial services business and include detailed requirements concerning nature of the business activities, the country where those activities are conducted and the location of customers. Transactions with U.S.-based customers do not qualify for the benefit of the AFE.

The AFE generally works well and serves to reduce unnecessary disparities between the treatment of financial services companies and other businesses. Whatever approach is chosen for tax reform, the AFE should be a permanent part of it. The AFE generally has been adopted as part of a time-limited package of "extenders," and perhaps for that reason neither taxpayers nor tax administrators have spent much time considering how the rules could be improved. Tax reform may provide a useful opportunity to make some modest clarifications in order to bring the AFE up to date.

But the most important thing is to preserve the principle that *active financial businesses should be treated the same as active manufacturing businesses* in order to allow U.S.-based multinationals to compete abroad. (Interest Expense: 95% exemption as a proxy for expense)

Allocation and Disallowance

The Camp bill as well as the Enzi bill would provide a dividend exemption for most—95%—but not all active foreign income. The 5% inclusion in U.S. taxable income, without any foreign tax credit for foreign taxes paid, represents a form of proxy tax on indirect costs, including interest expense, that are deemed to relate to foreign earnings.

Many countries have adopted this approach, which SIFMA strongly supports. The following section discusses the reasons why formulary apportionment of indirect costs would be inappropriate, and why other countries that have adopted a dividend exemption system do not require such apportionment.

Interest Expense Allocation Proposals

The formulary apportionment of a U.S. taxpayer's gross borrowing costs between domestic and foreign assets doesn't provide a reliable means of determining whether those costs genuinely represent a cost of earning foreign income. The most that can be said about the current interest allocation rules is that they may produce rough justice, and that their imperfections are tolerable—most of the time—because their only consequence is potentially to limit the amount of foreign tax credits that may be claimed in a particular year.

A rule that allocates U.S. interest expense for foreign source earnings through a formulary approach would have capricious, and potentially very unfavorable, consequences for companies that conduct diverse activities that don't support a uniform amount of leverage. Financial services companies have precisely these characteristics: they are highly leveraged, but the amount of permissible leverage, and the cost of funds, can vary substantially from activity to activity within the same enterprise.

Financial services companies conduct a range of business activities that are subject to widely varying regulatory capital requirements within and outside the United States. The amount of capital required to support an activity in turn determines the amount of leverage that it can support. Many assets are funded on a secured basis, which means that financing costs are determined in large part by reference to the nature of the collateral rather than the borrower's overall credit quality. The lowest-risk activities aren't subject to burdensome regulatory capital requirements, can support high leverage, and can be funded at a very low cost. Higher- risk activities are subject to more significant regulatory capital requirements, cannot support as much leverage, and require higher-cost funding. The attached example illustrates a case in which a financial services company conducts disparate businesses that are subject to different regulatory capital requirements and have widely varying funding costs. The company conducts a short-term repo business, and a commercial mortgage business in which it lends money to real estate developers. The repo business can support very significant leverage because the quality and liquidity of the collateral, and the term of the transactions, makes it a low-risk activity. Such a business typically will earn a small spread on a very large portfolio—tens of billions of dollars— of match-funded assets and liabilities. The commercial mortgage business is subject to higher regulatory capital requirements, and as a result is significantly less leveraged than the repo business. Nevertheless, the interest rate on borrowings incurred in connection with the commercial mortgage business is significantly higher than the cost of funds on the repos.

The potential for unreasonable consequences would be increased dramatically if the current-law methodology is converted into a rule that disallows U.S. tax deductions for interest expense, as the Obama administration has proposed. The consequences for financial services businesses would be particularly severe, for two reasons:

- First, U.S. interest expense that is wrongly attributed to foreign source income wouldn't be deductible anywhere, creating double taxation that a thoughtfully designed dividend exemption system is intended to eliminate.

- Second, the indiscriminate disallowance of deductions for interest expense would have severe consequences for low-risk (and low- margin) businesses that are important to the orderly functioning of the financial markets. If deductions are disallowed for even a small portion of the total interest expense incurred by a financial services company, the understandable behavioral response will be (i) to reduce exposure to low-margin businesses that cannot be conducted profitably unless costs are fully deductible; or (ii) to try to increase margins to offset the loss of deductions for interest expense, which in turn will reduce efficiency. Thus, the burden of an arbitrary disallowance rule will fall disproportionately on low- risk, high-volume, and low-margin businesses.

<u>Thin Capitalization Proposals</u>
Some commentators have expressed concern that the adoption of full or partial exemption system would enable U.S. taxpayers to exploit favorable mismatches by situating tax-deductible borrowings in the United States, and funding tax-exempt foreign operations with equity. The Camp bill responds effectively to this concern by providing a thin capitalization

rule under which tax deductions for *net* interest expense incurred by a U.S. company (that is to say, the amount by which payments of interest expense exceed receipts of interest income) would be disallowed to the extent that the company is deemed to have excessive leverage. The most important aspects of this proposal, from the perspective of financial services companies, are that (i) the proposal would apply to net rather than gross interest expense; and (ii) it does not involve the application of a formulary apportionment method, or a one-size-fits-all cap on the amount of permissible indebtedness. **These features are critically important to financial services companies.**

Treatment of Branches

An important design detail in developing a dividend exemption system will be determining what to do with active businesses conducted through foreign branches of U.S. companies. There are essentially two choices: (i) branch earnings could qualify for exemption or partial exemption treatment, under rules that recognize and take account of the fundamental differences between branches and subsidiaries; or (ii) branch earnings could be subject to current U.S. taxation as is the case under current law. This issue is particularly important for financial services businesses because they are the most significant industry group that conducts extensive activities through true foreign branches of U.S. companies. Whichever approach Congress decides to pursue, there will be many potential pitfalls. In particular, the issues that would need to be addressed in order to extend an exemption system to branches are qualitatively different, and significantly more complex, than the issues affecting subsidiaries. It will be critically important to get the details and transition right during the legislative process,rather than relying on a general grant of regulatory authority to address tough issues afterwards.

Transition Issues

Treatment of pre-effective date foreign earnings: The Camp bill would subject all pre-effective date non-previously taxed foreign earnings to a one-time tax. The bill has two rates of tax, one for cash of 8.75% and one for illiquid assets of 3.5%. The Administration's partial exemption plan includes one rate, set at 14%. Senator Enzi's bill would have taxed such earnings at a reduced rate upon repatriation, but unlike the Camp discussion draft would not require a mandatory deemed repatriation. These proposals would all minimize the burdens associated with the need to apply two inconsistent bodies of rules, under old law and new law. SIFMA believes that further thought should be given to the best way to achieve these important objectives.

- The mandatory repatriation approach doesn't take account of the fact that companies have reinvested earnings outside the United States in reliance on current law, and may not have the liquidity to support an actual dividend corresponding to the distribution that they will be deemed to make. For example,
    - A foreign subsidiary of a U.S. pharmaceutical company may have used its retained earnings to build a production facility; and

  - A foreign subsidiary of a U.S. bank may have used its retained earnings to increase its regulatory capital. Regulatory capital is the equivalent, for a financial services company, of a bricks-and-mortar facility for a manufacturing company, and can be just as permanent, and just as difficult to convert into free cash available for distribution.

- If Congress elects to proceed with a deemed repatriation approach, the details of determining the amount subject to tax will be critically important. In particular, foreign earnings should be determined on an aggregate basis, netting the earnings and tax history of all of a U.S. company's foreign subsidiaries. In addition, application of a lower tax rate to illiquid assets should also apply to the capital being held by regulated banks, which is the equivalent of illiquid assets, such as plant and equipment, of manufacturers.

FTC and ODL carryovers should be preserved: Current law provides important safeguards to protect taxpayers from the loss of tax credits for tax costs that they have actually incurred solely because of timing differences that prevent them from using those tax attributes immediately. The most important of these rules in the international context are the ability to carry over excess foreign tax credits ("**FTCs**") and to resource domestic income to offset the detrimental consequences of overall domestic losses ("**ODLs**").

The general principle underlying the U.S. foreign tax credit rules is that taxpayers are allowed to apply credits for foreign taxes on their foreign income to reduce the amount of U.S. taxes that they otherwise would be required in respect of the same income. The policy objective is to eliminate double tax costs (in recognition of the fact that a foreign country appropriately has primary taxing jurisdiction over income earned within its borders) without subsidizing foreign operations, by ensuring that foreign taxes are not applied to reduce U.S. taxes on U.S. income. The foreign tax credit rules work most efficiently in cases where a taxpayer's domestic and foreign operations are consistently profitable, or when bad times affect both sides of the business to the same extent. Current law provides for adjustments in order to avoid unintended costs or benefits in cases in which domestic losses offset foreign income, or *vice versa*, in a particular year. The ODL rules are intended to provide relief when this is not the case.

More particularly, the ODL rules provide relief in a case where a U.S. taxpayer cannot make use of credits for foreign taxes on its foreign income in a particular year because it has incurred domestic losses that wipe out its foreign income. A purely domestic business that incurred the same loss would be able to carry that loss forward and apply it against income earned in future years when its business has turned around. But if a U.S. company earns $100 of foreign income in the year in which it incurs a $100 domestic loss, it will have no net income, and no net operating loss carryover. If the foreign income is subject to foreign taxation at a 30% rate, the taxpayer will not be able to claim foreign tax credit benefits currently, because it won't have any U.S. income tax liability. The ODL rules remedy this problem by allowing a taxpayer to re-characterize domestic income as foreign income in succeeding years to the extent of the prior domestic losses.

In order to avoid profound unfairness, and the irretrievable loss of benefits for pre-enactment losses and taxes, the new rules should preserve the existing ODL rules and allow taxpayers to make use of FTC and ODL carryovers against post-enactment income without new restriction. These carryovers represent costs that taxpayers have incurred under current law, and for which Congress clearly intended to provide relief from double taxation. The ability to recover those costs should not be impaired or compromised by the enactment of tax reform.

Interest Allocation Example

This example illustrates that the *actual* cost of financing particular activities conducted by a multinational financial services company typically will bear no relationship to the *imputed* cost of funding those activities determined using a formula based on the company's debt-equity or interest-to-asset ratio.

A U.S.-based financial services group conducts two businesses in the United States, and one business in Japan. The group has $100 billion of assets and $10 billion of equity, and therefore has a debt-equity ratio of 9:1. It incurs interest expense of $2.28 billion, for an interest-to-asset ratio of 2.28%. The group conducts activities in the United States through a U.S. subsidiary and in Japan through a Japanese subsidiary. The U.S. and Japanese subsidiaries conduct commercial mortgage businesses of equivalent size. The businesses have the same risk profile, and are subject to the same regulatory capital requirements, in each country. (This of course will not necessarily be the case.[3]) The U.S. subsidiary also conducts a short-term secured lending business.

The U.S. and Japanese commercial mortgage businesses each have total assets of $25 billion that are supported by $4 billion of equity. The average cost of dollar-denominated borrowings to fund the U.S. business is 5%; the average cost of yen-denominated borrowings to fund the Japanese business is 3%.

The U.S. short-term secured lending business has $50 billion of assets that are supported by $2 billion of equity. Notwithstanding this leverage, the resulting $48 billion of debt can be financed at a 1.25% rate because the debt has a very short term, and is secured by high-quality

[3] Notwithstanding the complexity of the example, it represents a radical simplification of a much more complex reality. A typical multinational services company will conduct many businesses in many countries. Those businesses will be subject to regulatory capital requirements that vary from country to country; they will be funded in multiple markets, in multiple currencies, at widely varying rates. A formulaic allocation method will overstate the cost of financing some businesses, and understate the cost of others. As illustrated by the example, in some cases the blending of disparate activities within a single country will counterbalance the differences between countries.

assets. The commercial mortgage businesses incur higher funding costs because those businesses are funded with longer-term debt, some of which is unsecured.

An apportionment method that is based on the debt-equity ratio or gross interest expense of U.S. members of the group (either considered by themselves, as under current law, or in comparison to non-U.S. members of the group) has the potential to produce severe distortions. The U.S. subsidiary has a much higher debt-equity ratio than its Japanese counterpart, but this doesn't indicate that borrowings by that company are being used to support the Japanese businesses. All that the difference in debt-equity ratios indicates, on the facts of this example, is that a higher proportion of the U.S. subsidiary's businesses consist of low-risk activities that can support higher leverage and aren't subject to burdensome regulatory capital requirements.

On the facts of the example, the U.S. subsidiary would have a marginally lower interest-to-asset ratio than its Japanese counterpart, but this is an artifact of the assumptions. Depending on the mix of businesses conducted by the two companies, the regulatory capital requirements to which those businesses are subject in each country, and interest rates in local currencies and markets, there could be dramatic *apparent* differences in funding costs, but those differences would not provide any indication that borrowing costs incurred by the U.S. subsidiary *actually* represent costs of Japanese income. For example, if the U.S. and Japanese subsidiaries conducted exactly the same mix of businesses and are subject to exactly the same regulatory capital requirements, the U.S. subsidiary would have a significantly higher interest-to-asset ratio than its Japanese counterpart. This would result solely from the fact that prevailing rates for dollar-denominated borrowings are higher than prevailing rates for yen- denominated borrowings: no portion of the Japanese subsidiary's activities would be funded by U.S. borrowings.

Federal Tax Exemption for Municipal Bond Interest

The tax exemption on municipal bond interest has existed since the first federal income tax was enacted in 1913. State and local governments benefit from the tax exemption through significantly lower borrowing costs – municipalities save 2-3 percent on their borrowing rates relative to comparable taxable bonds.

Municipal bonds are used to finance a wide variety of infrastructure like schools, roads, bridges, airports, water and sewer systems, hospitals and many others. The tax exemption lowers the cost of financing these projects and encourages more infrastructure investment. The tax exemption is better than direct subsidies for infrastructure investment because bonds must be repaid, forcing a market test of the project's viability.

Additionally, tax-exempt bonds are bought widely by individual investors because they offer attractive, low-risk returns. Approximately 80 percent of municipal bonds are held by individuals, either directly or indirectly through mutual funds. The value of families' savings would be eroded significantly if Congress retroactively imposed a full or partial tax on municipal interest.

Pressure to close the federal budget deficit and to broaden the tax base in order to offset a reduction in tax rates under tax reform is causing Congress to consider curtailing "tax expenditures," including the municipal bond tax-exemption. For example, the Simpson-Bowles Commission report considered eliminating all tax-exempt bond issuance going forward. And, in its FY 2016 Budget, the Obama Administration proposed capping the value of many individual tax preferences, including the tax-exemption, at the 28-percent rate. Similarly, the Tax Reform Act of 2014 (H.R. 1, 113th Congress) would have imposed a 10-percent surtax on otherwise tax-exempt interest earned by certain taxpayers. While both these proposals would nominally affect higher-income taxpayers, in the long run, the tax would be borne largely by state and local governments in the form of higher financing costs. An unprecedented and particularly damaging aspect of both the Administration's proposal and the Tax Reform Act of 2014 is that both proposals would apply not only to newly issued or acquired bonds but also to outstanding bonds as well. Consequently, the negative effects of the proposals would extend to lower income investors through a reduction in the market value of their bonds. Also, the 28-percent cap is inconsistent with other elements of the administration's FY 2016 budget which are designed to promote and lower the cost of infrastructure investment.

Other proposals favor the use of taxable bonds with interest subsidies from the federal government, similar to the now-expired authorization of Build America Bonds. However, unlike Build America Bonds, these new taxable bonds, such as the administration's proposed America Fast Forward Bonds (AFFBs), would receive only a 28-percent subsidy, which may bring the proposal close to revenue neutrality. Given their recent experience with BAB subsidies—BAB subsidy payments have been reduced under sequestration—some issuers have expressed reservations about market acceptance of the President's new approach. Still, "direct-pay" bonds like AFFBs would provide a useful supplement to tax-exempt bond financing by attracting alternative categories of buyers like non-U.S. investors and tax-exempt investors such as pension funds to infrastructure projects.

The administration has also proposed a new category of tax-exempt bonds dubbed Qualified Public Infrastructure Bonds (QPIBs). QPIBS would provide targeted and limited debt financing for infrastructure projects with more than a *de minimis* level of private participation. For targeted, traditional infrastructure investments like roads, water and sewer systems, airports, transit systems and others, QPIBs would permit project developers to take advantage of lower tax-exempt borrowing costs for qualified projects involving public-private partnerships without the penalties normally associated with these types of financings, including state volume caps and imposition of the alternative minimum tax. QPIBs represent a creative idea worthy of serious congressional consideration.

Some have suggested that to make the tax code more progressive, Congress should repeal the exclusion and replace it with a tax credit that is equally valuable to all taxpayers, regardless of their income tax bracket.

In SIFMA's experience, tax credit bonds of the type where the credit accrues to investors have not achieved the level of market acceptance as traditional municipal bonds, so a wholesale transition to tax credit bonds would be risky for the market and for issuers. SIFMA is opposed to the Obama Administration's 28-percent cap proposal and any other full or partial taxation of municipal bond interest.

SIFMA Advocacy Links

- SIFMA issues 2015 municipal bond issuance survey, December 4, 2015
- SIFMA statements regarding President Obama's FY 2014 budget proposal dated Apr. 10, 2013
- SIFMA comment to House of Representatives dated Mar. 4, 2010

sifma
Invested in America

Tax Incentives for Retirement Savings

With the 2014 budget deficit totaling $506 billion dollars and the U.S. national debt hovering above $18 trillion dollars, tax reform and efforts to lower the deficit are a priority for Congress and the White House. Because of their tax-deferred status, retirement plans may come under scrutiny again as they have in the past. SIFMA participates in a coalition of service providers, plan sponsors and HR professionals - the Coalition to Protect Retirement - with the goal of preserving the tax incentives that are critical to encouraging Americans to save for retirement and to businesses sponsoring plans for employees.

Employer-provided retirement plans are a key component of our nation's retirement system. Together with Social Security and individual savings, retirement plans produce significant retirement benefits for America's working families. Currently, there are approximately 633,000 private-sector defined contribution plans covering over 75.4 million active participants and approximately 43,600 private-sector defined benefit plans covering over 15.7 million active participants.

- Existing retirement savings incentives have been a critical impetus for individuals to save and for employers to offer public and private retirement plans. Thanks to these incentives, tens of millions of Americans have been able to prepare responsibly for their retirement.
- These tax incentives have been an unqualified success – for retirees, employers, and taxpayers. They have done what they were intended to do; they trade immediate tax revenue for long-term federal savings that occur when retirees are financially secure.
- Retirement savings are a tax-deferral, not a tax exclusion. Reducing tax incentives may increase revenue in the short-term, but ultimately, discourage retirement savings. If retirement savings decline, the result will be reduced use of annuities among those who have come to rely on them the most – middle income earners.
- Proposed reforms to the retirement system should focus on increasing participation by encouraging employers to start new plans and continue current plans.

SIFMA Advocacy Links

- Joint trades comment to the U.S. Congress dated Sept. 4, 2012
- Joint trades comment to the House Ways and Means Committee dated April 17, 2012
- Joint trades statement for the record submitted to a U.S. House Committee on Education and the Workforce Subcommittee dated June 14, 2011

Invested in America

Capital Gains and Dividends

SIFMA and its members consistently have advocated for low federal income tax rates on savings and investment. SIFMA helps to lead a coalition of U.S. companies and trade associations – the Alliance for Savings and Investment (ASI) – that supports low capital gains rates and parity between the rates for capital gains and qualified dividends. We believe that these preferential rates provide a necessary and powerful incentive for investments that benefits retail investors and strengthens the U.S. economy, and that Congress and the Committee should be mindful of preserving these incentives as discussions about tax reform unfold.

The treatment of capital gains and dividends has seen some significant developments that have resulted in higher taxes for investors. The American Taxpayer Relief Act of 2012 (ATRA) signed into law in January 2013, made permanent the 15% rate for both long-term capital gains and qualified dividend rates for those with taxable income below $400,000 (single filers), $425,000 (heads of households) or $450,000 (married couples filing jointly), indexed for inflation in future years. Taxpayers with incomes above those thresholds are subject to tax on capital gains and qualified dividends at a 20% rate.

In addition, the Affordable Care Act (ACA), signed into law by President Obama in 2010, applied a 3.8 percent Medicare tax to investment income for individuals and married couples filing jointly whose adjusted gross incomes exceed $200,000, and $250,000 respectively. The tax on investment income became effective in January 2013. This tax reduces the benefit of the preferential rate for capital gains and dividends and must be taken into account when Congress addresses federal tax policy in this area. Where a taxpayer is subject both to the higher 20% rate under ATRA and the Medicare surtax, capital gains and qualified dividends are subject to a combined 23.8% rate. Recent tax plans would have, in most cases, left the U.S. with top integrated tax rates which remain among the highest of the developed nations.

A recent analysis by Ernst & Young for the Alliance for Savings & Investment found that for 2014, the U.S integrated tax rate on corporate profits are among the highest in developed nations. The integrated tax rate has increased over the past several years due to the reforms mentioned above, while the top integrated tax rate has fallen in many other countries since 2000. Taking into account both the corporate- and investor-level taxes on corporate profits at the national and sub-national level, in 2014 the United States has the second highest top integrated tax rates on both dividends and capital gains among developed countries.

The top U.S. integrated dividend tax rate is 56.2%, while the average integrated tax rate among OECD and BRIC countries (weighted by GDP and excluding the United States) is 44.5%. In other words, the US rate is nearly 12 percentage points higher than the prevailing average among OECD and BRIC countries. The top US integrated long-term capital gains tax rate is 56.3%, while the average integrated tax rate among OECD and BRIC countries (weighted by GDP and excluding the United States) is 40.3%. The U.S. rate is 16 percentage points higher than the prevailing average among OECD and BRIC countries.

SIFMA continues to believe that if Congress considers further increases in the tax rates applicable to capital gains and qualified dividends, policy makers should take into account the negative impact of higher capital gains rates on realization, and the drag on economic growth that might result from further bias away from savings and towards current consumption in federal tax law.

SIFMA Advocacy Links
• Ernst and Young Study, "Corporate dividend and capital gains taxation: A comparison of the United States to other developed nations," April 2015

Invested in America

Tax Classification of Independent Contractors

Issue

For federal tax law, the question of whether a worker is classified as an employee or as an independent contractor has important consequences. The business model of many securities firms is built on a 'dual-track' structure under which some brokers are classified as employees and others as independent contractors. Securities firms have relied on their good-faith compliance with long-standing provisions of law in maintaining this proven and successful business model.

Background

In 1978, in response to a series of Internal Revenue Service actions requiring companies to reclassify workers as employees, Congress imposed a two-year moratorium on the issuance of any general guidance from the IRS reclassifying workers. In 1980 Congress extended the moratorium for an additional two years, and in 1982 made the moratorium permanent. It remains in effect. The moratorium includes a safe harbor under which classifications of workers as independent contractors cannot be challenged if the company's practices are consistent with long-standing industry practices.

Congress has revisited this issue many times since the imposition of the moratorium. Most recently, in 2013 and 2014, Senator Sherrod Brown (D-OH) and Rep. Jim McDermott (D-WA) introduced companion bills to repeal the 1978 moratorium, including the safe harbor on long-standing industry practices, on the issuance of guidance by the IRS requiring the reclassification of workers. Both bills were titled "The Fair Playing Field Act" (S. 1706, HR 4053) and they are similar to a proposal included in the Obama Administration FY 2016 budget.

The bills were also identical to the legislation that former Senator John Kerry and Rep. McDermott had introduced in prior Congresses, with one notable change related to the securities industry. The bills included a special provision relating to the status of broker-dealers. The language provided that for purposes of determining whether a registered representative of a securities broker-dealer is an employee, "no weight shall be given to instructions given by the service recipient (employer) which are imposed only in compliance with investor protection standards imposed by the Federal government, any State government, or a governing body pursuant to a delegation by a Federal or State agency." This language corresponds to a provision Congress enacted into law in 1997 under which the "duty to supervise" imposed by securities laws would not impact the worker classification determination. The Fair Playing Field Act has not been reintroduced in the 114th Congress.

Toward the end of the 112th Congress, Rep. Erik Paulsen introduced a contrasting piece of legislation, H.R. 6653, the "Independent Contractor Tax Fairness and Simplification Act of 2012." The Paulsen bill would preserve the safe harbor that the Kerry-McDermott bill proposed to repeal, and also create a new safe harbor for determining employment status. Similarly, former Chairman Dave Camp's "Tax Reform Act of 2014" (H.R. 1) would preserve the safe harbor and create a new optional safe harbor that differed from the approach adopted by Rep. Paulsen but generally would add flexibility to worker classification options.

Finally, in the 113th Congress, Sen. Sherrod Brown introduced a worker classification amendment to the highway bill that would "permanently preserve" the safe harbor for professional services, which is defined to include services performed in a number of fields, including "financial services and insurance." While the amendment ultimately was withdrawn, Senator Brown has signaled his intention to preserve the professional services safe harbor when he reintroduces his legislation in this Congress.

SIFMA recognizes that a law which establishes a moratorium on tax regulations in any area is a poor substitute for comprehensive legislation in this area. Nevertheless, our members remain concerned that poorly considered changes could inadvertently harm securities industry professionals who are operating well within the bounds of the law and who have made important decisions on the expectation that the rules will not be abruptly changed. We believe any new legislation - - if it does not preserve the status quo - - should be narrowly focused on the concerns Congress wishes to address, and should not apply to industries, such as the securities industry, that have long and unchallenged records of no abuse of worker classification rules.

SIFMA Advocacy Links
• SIFMA statement regarding President Obama's FY 2014 budget proposal dated Apr. 10, 2013

Financial Transaction Tax (FTT)

Harmful Economic Effects of an FTT

SIFMA is opposed to the imposition of a financial transaction tax – domestically, globally, or extraterritorially – and encourages Congress and the Administration to consider the lessons of past efforts to implement FTT laws in other nations. SIFMA believes an FTT would raise the cost of capital needed by businesses. It would amount to a new sales tax on retirees and middle class investors.

The idea of imposing a small excise tax on all financial transactions is an old idea with a history of unintended consequences. Although stamp and stock taxes existed earlier and still are levied in some jurisdictions, the idea of taxing all financial transactions at a very low rate is often attributed to Yale University economist James Tobin and referred to as a "Tobin" tax. Professor Tobin later abandoned the idea.

A domestic FTT law could also place the United States at a competitive disadvantage compared to other financial markets. If a tax is only imposed regionally, essential businesses and markets are likely to move to other jurisdictions. Many economists believe that an FTT would cause shifting of transactions to other markets, less liquidity, and a significant increase in the cost of capital that could cause slower growth and increased unemployment in the regions most affected.

SIFMA Advocacy Links

- SIFMA Statement on Rep. Van Hollen's Tax Reform Action Plan, January 12, 2015
- SIFMA Statement on House Republican Tax Reform Proposal, February 26, 2014
- SIFMA Statement on Baucus' Tax Reform Discussion Draft, November 20, 2013
- GFMA comments to the G20 Central Bank Governors dated July 16, 2013
- GFMA study on EU FTT impact on FX Transactions dated July 7, 2013
- SIFMA press release commending Rep. Price, Sen. Roberts FTT legislation dated June 27, 2013
- SIFMA comment to Treasury Secretary Jack Lew dated Apr. 3, 2013
- Joint Trades comment to European Commission dated Feb. 13, 2013
- SIFMA-ICI Request to IRS Requesting Competent Authority Assistance under the U.S.-France Tax Convention dated Dec. 21, 2012
- Joint Trades comment to Treasury dated Nov. 6, 2012
- SIFMA comment to Treasury dated Jun. 14, 2012
- GFMA comment to G20 finance ministers dated Sept. 23, 2011
- SIFMA comment to Treasury dated Sept. 22, 2011