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 in the context of tax reform and is in response to the request for stakeholder comments on tax reform that was issued on June 16, 2017 by Senate Finance Committee Chairman Orrin Hatch (R-UT).

July 17, 2017

[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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SIFMA Supports Pro-Growth, Comprehensive Tax Reform

SIFMA commends the Chairman and the Committee for taking the initiative to work with the Trump Administration and the House of Representatives to develop a framework for legislation to modernize and simplify both the U.S. business and individual tax system. SIFMA supports tax reform that enhances economic opportunities for individual Americans, promotes savings and encourages investment, and lowers the tax rate for American businesses that compete in a global marketplace where the U.S. tax rate is an outlier and the U.S. international tax system is out of step with our global competitors.

Therefore, SIFMA supports movement by the United States to a territorial tax system that recognizes the unique characteristics of the financial services industry, a transition to such a system that is fair and equitable for U.S. financial services companies and investors, and tax rules for inbound investment that encourages foreign investment in the United States and does not discriminate against non-U.S. financial services companies seeking to compete in U.S. markets.

Taxation of Interest

Discussions surrounding comprehensive tax reform often include some consideration of the tax treatment of interest income and expense. Over the years, several tax reform plans have incorporated proposals to limit the deductibility of business interest expense, 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 Obama Administration's FY2016 budget proposal to limit the net interest expense deduction of a U.S. corporate taxpayer that is a member of a worldwide consolidated group, the comprehensive income tax reform bill introduced by Sens. Ron Wyden (D-OR) and Dan Coats (R-IN) in the 112th Congress and, most recently, the June 2016 House Republican Blueprint for Comprehensive Tax Reform, which proposed repealing the deduction for net interest expense.

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 expense is the excess of interest expense over interest income. Moreover, as discussed further below, it is critical that application of the net interest proposal take into account those financial institutions that fund themselves with debt but which earn income that is not always interest in form. Finally, it is important that any such proposal reflect the structure of most financial institutions, and thus impose limitations on a group-wide rather than an entity-by-entity basis.

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. In light of these consequences, it is critical that policymakers plan to adopt appropriate transition rules that preserve investors' settled expectations to the greatest extent possible.

I. Limitations to Address the Bias for Debt v. Equity

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. 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.

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.

II. U.S. House Blueprint Net Interest Expense Proposal

The House Republican Blueprint on tax reform recognizes the fundamental importance of interest expense for financial services businesses. The proposal to disallow deductions only to the extent of net interest expense (the amount, if any, by which interest expense exceeds interest income) reflects an appropriate understanding that, for financial services businesses, interest expense represents the cost of goods sold. In its discussion of the proposal, the Blueprint indicates that the Ways and Means Committee "will work to develop special rules with respect to interest expense for financial services companies, such as banks, insurance, and leasing, that will take into account the role of interest income and interest expense in their business models."[2]

A. Interest Equivalents

Specifically, for banks that are largely deposit-taking institutions, a limitation on net interest expense largely recognizes and accommodates the fact that interest is their cost of goods sold. However, the net profits earned by a market-maker in government bonds, for example, are not economically equivalent to interest. Neither is a dividend received by a dealer in equities. A generally applicable definition of "interest equivalents" that is broad enough to encompass those dealer profits or that dividend income would be unworkable when applied to other industries: it would create an unacceptable degree of uncertainty, and unacceptable opportunities for manipulation, for nonfinancial businesses. Such a rule would only work, and would only make sense, if it applied to banks and broker-dealers and not to nonfinancial businesses. For that reason, we have not endeavored to set out a generally applicable rule that defines interest equivalents for all industries, and have instead focused our recommendations on rules unique to the financial services industry.

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2 A Better Way Forward: Our Vision for a Confident America, June 24, 2016 at p. 26 (the "Blueprint").

We recommend that:

1. The amount of net interest expense should be determined on a group-wide basis; and

2. Amounts should be treated as interest income, solely for purposes of the net interest disallowance rule, if they constitute financial services income, including ordinary trading or ordinary investment income, *and* are derived by an entity or group whose business or activity primarily consists of the active conduct of a banking, insurance, financing or broker-dealer business, or of trading or investing in stocks or securities.

Taxation of Financial Products

Recent plans to reform the tax code have included changes to the taxation of financial products.

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. We believe some of the proposals in the bill 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.

Senate Finance Committee Ranking Member Ron Wyden (D-OR) has also pursued reform of the tax treatment of financial products, beginning with a March 2015 report on "How Tax Pros Make the Code Less Fair and Efficient: Several New Strategies and Solutions," a 2016 discussion draft, and revised version of that discussion draft introduced as legislation on May 2, 2017, known as the Modernization of Derivatives Tax (MODA) Act of 2017 (S. 1005).

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. 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 94 million American investors in just under 55 million households hold investments in one or more of the above asset classes;

- **Significant in Value** - - Non-business investors hold over $4.5 *trillion* in mutual funds assets outside of a traditional retirement account according to recent survey estimates by the Investment Company Institute; and

- **Often Held by Middle-Income Investors** - - Fifty-one percent of households that own mutual funds and ETFs have household income of less than $100,000. Eighty-nine percent have household income under $200,000. It has been estimated that close to 20 percent of volume on U.S. options exchanges is attributable to individuals.

Indirectly (through mutual funds and other investment vehicles), individuals represent an even greater percentage of volume.

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 the Committee 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; coordination between the new regime and the existing straddle rules; the definition of a derivative; and record keeping and reporting associated with the new rules.

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 mark-to-market proposal would likely create substantial interpretive and compliance problems, which could frustrate the policy of Congress to have the financial services industry report accurate basis information. Our members have spent significant resources building compliance systems and training personnel to report tax basis to investors. Many of these systems would need to be re-designed.

Unintended Consequences

Any proposal to change the way gain is recognized with respect to a broad category of financial products is inherently complex and our members are concerned that some of the uncertainties in the application of such proposals 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 difficult and the end-result will be a more complicated, not a simpler, tax code.

The current rules are complex and often drive towards poor outcomes. We believe that economically similar financial instruments including stock and derivatives should be treated, for tax purposes, in similar fashion. Hedging rules should operate similarly to the commercial hedging rules now in place.

We remain concerned that a regime that taxes derivatives differently than their underlying physical position creates an unjustifiable difference between the tax treatment of economically identical investments – a leveraged cash investment in securities (realization, capital) and a derivative over those securities (mark-to-market, ordinary). Economic disparities like this have been shown to perpetuate and exacerbate inconsistencies rather than eliminate them. It has been a long-standing general principle of our tax system that economically identical investments should be taxed in the same manner.

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 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 discussion drafts have been put forward to harmonize the U.S. system with those of other developed countries.

SIFMA believes that a well-crafted exemption system, with appropriate safeguards against base erosion, would be strongly beneficial to the United States 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. Therefore, assuming a Subpart F regime or analogous anti-base erosion measures are 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, broker dealers, and other financial services firms.

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.

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 do not 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. These regulatory restrictions apply to banks and broker dealers, as well as to asset managers.

We face *multinational and local competitors*. We compete in foreign markets with local as well as global banks, securities dealers, and asset managers. 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. 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 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 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.

Thin Capitalization Proposals

Some commentators have expressed concern that the adoption of a 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 a tax deduction 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. For reasons more fully described in the discussion above on taxation of interest, SIFMA would argue for a broad definition of interest for purposes of any net interest expense rule. 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: President Trump's tax reform plan, the Blueprint, and the 2014 Camp bill have a transition rule that would subject all pre-effective date non-previously taxed foreign earnings to a one-time tax. Both the Camp bill and the Blueprint have two rates of tax, one for cash of 8.75 percent and one for illiquid assets of 3.5 percent. 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 and attributes 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, broker dealers and asset managers, 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 to pay 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 percent 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 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

[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.

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 percentage points 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. Around two-thirds 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.

A focus on fundamental tax reform is causing Congress to consider curtailing "tax expenditures," including the municipal bond tax-exemption. For example, 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 and would have banned "private activity bonds." 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 proposals is that they 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, curtailing the tax exemption is inconsistent with the Trump administration's focus on promoting and lowering the cost of infrastructure investment.

Municipal bonds and infrastructure

The U.S. faces an extraordinary "infrastructure deficit." The Trump administration has made infrastructure finance a key element of its agenda. New initiatives for infrastructure finance should recognize the need for a partnership among federal, state and local governments and private investors and developers. A comprehensive expansion of federal investment in infrastructure should include the following initiatives.

Preserve the federal tax-exemption for interest earned by investors on bonds issued by states and localities to finance infrastructure. The majority of our nation's infrastructure is financed, built and maintained by state and local governments. The tax-exemption for municipal bond interest is the single most important tool the federal government provides to lower the cost to states and localities of infrastructure finance. It should be preserved in its present form.

Expand the use of "private-activity" tax-exempt bonds for infrastructure. State and local governments are permitted under the tax code to issue bonds on behalf of private borrowers for a limited list of uses, including infrastructure. However, this issuance comes with significant restrictions like volume limitations and application of the individual Alternative Minimum Tax, which raises the cost of financing. State and local governments should be able to issue tax-exempt bonds for infrastructure projects with private participation in the same manner that they issue bonds for purely public projects.

Provide a tax credit for equity investors in infrastructure projects. Public-private partnerships between state or local governments and private developers can provide a meaningful supplement to purely public infrastructure development. The federal government should provide a tax credit to private investors who commit equity capital to infrastructure projects. To maximize efficiency, the credit could be sold to other investors and the proceeds used to defray project costs. Similar federal programs have been successful in promoting investment in renewable energy generation and low-income housing.

Reinstate "direct pay" bonds for infrastructure. In 2009 and 2010 the federal government operated programs such as "Build America Bonds" whereby states and localities could choose to issue bonds with taxable interest instead of tax-exempt interest and receive a partial reimbursement for their interest expense. These initiatives were very successful in generating new investment in public infrastructure, and Congress should reinstate them on a permanent basis as a supplement to, not a replacement for, tax-exempt bonds. The program should be structured such that reimbursements to borrowers are not affected by budget sequesters.

SIFMA Advocacy Links
• SIFMA Statement on Move America Act of 2017, June 2, 2017 • SIFMA Statement on Move America Act of 2015, May 4, 2015 • 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

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Tax Incentives for Retirement Savings

With the 2017 budget deficit totaling $693 billion dollars and the debt held by the public hovering above $14 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 provided 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 tax-deferred, not excluded from tax. Reducing tax incentives may increase revenue in the short-term, but ultimately, this will discourage retirement savings. Any decrease in retirement savings would have a broad economic impact as moderate income individuals turn to reliance on other government services.
- Proposed reforms to the retirement system should focus on increasing participation by encouraging employers to start new plans and continue current plans, while also encouraging employees to save, whether in or outside of a retirement plan. Both employers and employees have a role to play.

SIFMA Advocacy Links
• SIFMA, as part of a Coalition, comments to the Senate Finance Committee on tax reform and the impact on retirement plans, dated April 15, 2015 • Joint trades comments to the Senate Finance Committee on preserving the employer-provided retirement system, dated July 15, 2013

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Unintended Consequences of a Tax on Bank Lending

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 Obama Administration renamed the proposal the "Financial Fee" and explained that its purpose is to reduce the incentive for financial firms to undertake "excessive risk." Similarly, in 2014, as part of his Tax Reform Act of 2014, then-House Ways and Means Committee Chairman Dave Camp (R-MI), included a new excise tax on systemically important financial institutions, otherwise known as the SIFI tax. In an explanation of the bill prepared by House Ways and Means Committee staff, it was contended that such a tax "would address the significant implicit subsidy bestowed on big Wall Street banks and other financial institutions under Dodd-Frank. By deeming SIFIs to be 'too big to fail,' Dodd-Frank effectively subsidizes these big banks and financial institutions . . . while tax reform cannot undo Dodd-Frank, it can and should help recapture a portion of that implicit subsidy."

SIFMA has serious concerns with 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 to 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 dubious economic theories in which the federal government picks economic winners and losers. 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

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 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.

Earlier, 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 in any OECD country.

A 2015 analysis by Ernst & Young for the Alliance for Savings & Investment found that 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) was 44.5% during the last year studied. 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 was 56.3%, while the average integrated tax rate among OECD and BRIC countries (weighted by GDP and excluding the United States) was 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

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 2015, Senator Sherrod Brown (D-OH) introduced legislation 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. The bill was titled "The Fair Playing Field Act" (S. 2252) and was similar to a proposal included in the Obama Administration's budget.

Senator Brown's legislation included language carving out "professional services workers," and defined the term to include workers in financial services. The bill also 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 115th Congress.

In the House of Representatives in 2015 Rep. Erik Paulsen proposed a contrasting piece of legislation, H.R. 2483, the "Independent Contractor Tax Fairness and Simplification Act of 2012." The Paulsen bill would preserve the safe harbor that the Brown legislation would repeal, and also create a new safe harbor for determining employment status. Similarly, former Ways and Means Committee Chairman Dave Camp's "Tax Reform Act of 2014" (H.R. 1) would have preserved 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.

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

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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