Securities Industry Association
1425 K Street, NW • Washington, DC 20005-3500 (202) 216-2000 • Fax (202) 216-2119 •
www.sia.com, info@sia.com

February 17, 2004

Barbara Angus
International Tax Counsel
Office of Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, N.W.,
Washington, D.C. 20220

Dear Barbara:

We are writing in regard to Article 11 (Interest) of the new income tax treaty between the United States and Japan, signed on November 6, 2003 (the "Treaty"). That article permits either country to impose a 10% withholding tax on interest paid to residents of the other country, subject to certain exceptions. Pursuant to the exception set forth in subparagraph 3(c) of Article 11, no withholding tax may be imposed by a country with respect to interest that is beneficially owned by a resident of the other country that is:

(i) a bank (including an investment bank);

(ii) an insurance company;

(iii) a registered securities dealer; or

(iv) any other enterprise, provided that in the three taxable years preceding the taxable year in which the interest is paid, the enterprise derives more than 50 percent of its liabilities from the issuance of bonds in the financial markets or from taking deposits at interest, and more than 50 percent of the assets of the enterprise consist of debt-claims against persons that do not have with the resident a relationship described in subparagraph (a) or (b) of paragraph 1 of Article 9.

It is common among U.S.-based securities firms that have foreign subsidiaries to finance the foreign subsidiary with loans made directly from the U.S. parent holding company. Similarly, Japanese-based securities firms with U.S. subsidiaries often finance these subsidiaries with parent company loans. This is because the parent is typically the member of the group that has the greatest ability to raise capital from third party investors or commercial lenders. Moreover, where the parent serves solely or principally as a holding company for the worldwide group, the parent is not normally subject to regulatory requirements that could limit related party financing. Other subsidiaries, such as regulated broker-dealers, are subject to such requirements.[1]

[1] Alternatively, such loans might be made from an unregulated finance subsidiary within the group.

We are concerned that interest paid by a Japanese subsidiary to the U.S. parent of a securities firm (or by a U.S. subsidiary to a Japanese parent of a securities firm) in these circumstances would appear to be subject to withholding tax under the Treaty, unless the parent corporation can be considered an "investment bank" for purposes of the Treaty.[2] The term "investment bank" is not defined in the Treaty, however, and we are not aware of a single, commonly-accepted definition for tax or other purposes. We believe, therefore, that it would be useful to clarify the meaning of this term for purposes of the Treaty, either in the Technical Explanation of the Treaty prepared by the Treasury Department or otherwise.

In this regard, there are two very recent developments that provide useful analogies. First, the Mexican tax authorities recently issued new rules that effectively define the term "investment bank" for purposes of the United States income tax treaty with Mexico, as well as Mexico's other income tax treaties and internal law. Article 11 of the U.S.-Mexico treaty provides for a reduced rate of Mexican withholding tax for interest derived from "loans granted by banks, including investment banks and savings banks, and insurance companies…" In order to take advantage of this provision, a U.S. financial institution must register with the Mexican tax authorities as a bank or investment bank. Under the new Mexican regulations,[3] a regulated financial services entity, such as a broker-dealer, can register as an "investment bank" and may also register an unregulated affiliate that is 80-percent owned by a common parent and that is engaged in broker-dealer, intermediary, investment advisory or similar services.

Second, in the context of securities regulation, the Securities and Exchange Commission (SEC) recently proposed rules to implement Section 17(i) of the Securities Exchange Act of 1934, which created a new framework for supervising an investment bank holding company ("IBHC").[4] An IBHC that meets certain criteria may voluntarily file a notice of intention with the SEC to become a supervised IBHC and be subject to supervision on a group-wide basis. The IBHC rules are intended to enhance the SEC's ability to supervise broker-dealer subsidiaries within the IBHC group. In addition, the rules are intended to provide a mechanism for securities firms that do business in the European Union (EU) to demonstrate that they are subject to consolidated supervision at the holding company level that is equivalent to EU consolidated supervision (and therefore that they need not form a sub-holding company in the EU or incur additional capital charges in order to continue doing business in the EU).

---

[2] A parent holding company that conducts no operating business of its own is unlikely to qualify as a "bank" or "insurance company" under common definitions of those terms, and would not normally meet the 50 percent tests of clause (iv) of subparagraph 3(c).

[3] Rule 3.23.13 of the Temporary Regulations to the Income Tax Law, issued on December 30, 2003.

[4] Section 17(i) was enacted as part of the Gramm-Leach-Bliley Act of 1999. The SEC's proposed rules are set out in Release No. 34-48694, File No. S7-22-03, RIN 3235-AI97, published in the Federal Register on November 6, 2003.

For purposes of the statute and these proposed rules, the term “investment bank holding company” is defined in Section 17(i)(5) of the Act as:

i. any person other than a natural person that owns or controls one or more brokers or dealers; and

ii. the associated persons of the investment bank holding company.”

These two definitions share a common element -- in order to fall within the scope of the term “investment bank”, a financial services entity must be related to a regulated broker-dealer. In other words, an entity that merely performs investment or other advisory services would not qualify as an “investment bank” unless it is part of a larger group that also includes a regulated broker-dealer. We believe that the requirement of a relationship to a regulated broker-dealer is a useful way to distinguish the pool of financial institutions that might qualify as “investment banks” from those that would more appropriately be characterized as banks or insurance companies.[5] Further, most of the U.S.-based or Japanese-based securities firms that conduct the type of active financial business at which the Treaty exception seems to be aimed, include within their U.S. or Japanese group a regulated broker-dealer subsidiary. We recommend, therefore, that consideration be given to defining the term “investment bank” for purposes of Article 11 of the Treaty to include a regulated broker-dealer and its affiliates (determined based on 80-percent common ownership). We believe that this definition would both clarify and limit the scope of the exception for interest paid to “investment banks” in paragraph 3(c) of Article 11.

We would appreciate the opportunity to discuss this issue with you or your staff if you believe that would be useful. Please contact Emily McMahon of Sullivan & Cromwell, SIA’s outside counsel on this matter, (at 202-956-7675) with any questions you may have.

Sincerely yours,

Patti McClanahan
Vice President and Director for Tax Policy
Securities Industry Association

cc: Rocco Femia
(Department of the Treasury)

[5] A distinction based on the range of services that these different groups might be expected to provide would be more difficult to draw.