



Securities Industry Association

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January 9, 2003

The Honorable Charles E. Grassley
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Max Baucus
Ranking Minority Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Grassley and Senator Baucus:

As you continue your work examining our country's international tax laws, the Securities Industry Association (the "SIA")¹ appreciates the opportunity to present the following summary of the international legislative tax issues that are important to our member firms. We look forward to working with you and your staffs over the coming months as you consider changes to modernize and simplify our seriously outdated international tax regime.

I. SUBPART F OF THE CODE.

1. Active Financial Services Provision.

Background: Congress enacted crucial but temporary reforms of the international tax rules for financial services firms in the Taxpayer Relief Act of 1997. As a result of these reforms, "active financing income" earned by foreign subsidiaries of U.S.-based financial services firms now is taxed in the same general manner as the active business income earned by foreign subsidiaries of U.S.-based industrial firms.

¹ The Securities Industry Association brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. Collectively they employ more than 495,000 individuals, representing 97 percent of total employment in securities brokers and dealers. The U.S. securities industry manages the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2001, the industry generated \$280 billion in U.S. revenue and \$383 billion in global revenues.

Since 1997, Congress has renewed the active financial services provision three times. In the Tax and Trade Relief Extension Act of 1998 (included in the omnibus FY 1999 appropriations legislation), Congress modified and extended the provision for *one additional year*. In 1999 Congress extended the 1998 provision, this time for *two years*, in the Tax Relief Extension Act of 1999. Finally, in the recently enacted Job Creation and Worker Assistance Act of 2002 the provision was extended for *five years*.

Proposal: The SIA urges that the Code's active financing income rules be made permanent. *This issue is the single most important international tax legislative priority of the SIA.*

As Congress recognized in 1997, 1998, 1999 and again in 2002, a U.S.-based financial services firm should not be liable for U.S. tax on the active business income earned by its foreign subsidiaries until those earnings are returned to the U.S. parent. Foreign-based competitors have always enjoyed either delayed taxation of such income or total home country exemption from tax. Similarly, U.S.-based industrial firms have never been subject to the immediate tax regime of subpart F in respect of the overseas business income of their foreign subsidiaries.

The current active financing income rules have been in place since 1998, and are working well. Now that the statutory drafting has been validated by experience, the temporary provisions should be made permanent, to allow financial services firms to formulate long-range business plans in a stable and appropriate business environment. We therefore urge that the active financing income rules be made permanent as soon as possible.

2. Section 956 – Investment in United States Property.

See our proposals regarding this important Code provision in Part III, below.

II. FOREIGN TAX CREDIT PROVISIONS.

1. Interest Allocation.

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

Section 311 of H.R. 5095 would replace the 'water's edge' formula with a simplified apportionment formula, which would require taxpayers to allocate their interest expense using a 'worldwide fungibility' approach. This approach in effect views each asset of a global company as debt-financed to the same extent and at the same financing rate as every other asset of the company, including for this purpose all the assets and borrowings of all domestic and foreign subsidiaries.²

The apportionment formula of H.R. 5095 effectively assumes that a multinational group's domestic and international businesses are similar in their capital needs, and that money is perfectly fungible across all of the group's worldwide operations. In reality, of course, these assumptions are never perfectly correct, either with respect to the leverage of different domestic and foreign operations, or the different financing rates available in the U.S. and foreign markets.

U.S.-based securities dealers have adapted their operations as best as they can to the current tax regime. Some dealers, like most industrial firms, find the current rules to be unfair, because their domestic and foreign business profiles are similar, and H.R. 5095's premise of the worldwide fungibility of money therefore reasonably describes their operations. Other dealers, however, have found that H.R. 5095 would only make matters worse, because of significant differences between the kinds of businesses they conduct domestically and internationally (and therefore the leverage or financing rates applicable to each). Because securities dealers are very highly leveraged compared to industrial firms, any differences between commercial reality and the theoretical construct of worldwide fungibility are greatly magnified in the financial services industry.

As an example, imagine that a U.S. securities dealer holds in inventory \$1000 of long-term U.S. Treasury bonds yielding 5.5% interest annually, which it finances by borrowing at 5%, using the bonds as collateral (technically, by engaging in a "sale and repurchase" of the bonds, referred to as a "repo" transaction). The dealer's financing profit would be 0.5% per year, or \$5.00 (\$55 coupon interest income less \$50 interest expense). Now assume that the same dealer also has a Japanese dealer subsidiary, whose facts are identical, except that it holds long-term Japanese Government Bonds yielding 3.5%, financed by borrowing at 3% (again, by means of a "repo" transaction). The Japanese dealer subsidiary would earn the same \$5.00 of net financing profit (\$35 coupon interest income less \$30 interest expense). Under a worldwide fungibility principle, however, both the U.S. securities dealer and Japanese securities dealer would use a global blended financing rate of 4.0% -- with the result that, for foreign tax credit purposes, the U.S. business would be treated as earning \$15.00 (\$55 less \$40 interest expense), and the Japanese business as *losing* \$5.00 (\$35 less \$40 interest expense)! The Japanese government will fully tax the \$5.00 of economic profit earned in Japan, *and so will the United States*, without any offsetting credit for the Japanese taxes that the dealer paid.

² A similar provision was included in the Taxpayer Refund and Relief Act of 1999, which was passed by the House and Senate on August 5, 1999, but was subsequently vetoed by President Clinton.

Proposal: In order to address the anomalous effects of the interest allocation rules in both current law and H.R. 5095, we propose that financial services groups be permitted to elect to allocate their interest expense under pre-H.R. 5095 law, or alternatively to apply H.R. 5095, depending, in effect, on which regime more closely describes their business model. We suggest that the election be made once every five years. This would prohibit attempts to game the system, but would permit taxpayers to revise their elections as their long-term business strategies (and hence mix of business) evolve. The election should apply only to taxpayers that are *bona fide* financial services groups – *i.e.*, those groups that meet the qualitative and quantitative income requirements for the group as a whole to qualify as a financial services entity for foreign tax credit purposes.³

In addition, consideration could be given to reducing the cost of such an election, and simplifying its administration, by providing that current law's financial institution subgroup rule (section 864(e)(5)) – as well, of course, as H.R. 5095's proposed elective extension of the subgroup rule (proposed section 864(e)(6)) – would *not* apply to a financial services group that elects to allocate interest expense under pre-H.R. 5095 law.

Finally, if worldwide fungibility is enacted for any group of taxpayers (industrial or financial), the application of those rules to intercompany debt owed by foreign subsidiaries to the U.S. parent must be addressed. Loans from a U.S. parent group to its foreign subsidiaries should be treated as follows: (i) only third-party interest expense should be subject to the worldwide fungibility rules; (ii) third-party interest expense should be allocated by reference to third-party assets of the U.S. parent group and its foreign subsidiaries (*i.e.*, by disregarding the intercompany debt and any equity in the foreign subsidiaries as assets of the U.S. parent), and (iii) for all other purposes, including the determination of how much foreign source income the U.S. parent earns, intercompany interest earned by the U.S. group should be treated as real foreign-source income, to the same extent a dividend from the foreign subsidiary would be. It is tempting to suggest that this is the sort of technical matter best left to regulations, but in light of the amount of intercompany debt outstanding among multinational groups today, and the confusion that would result if implementing regulations either were not issued quickly or were not clear, it is imperative that a worldwide fungibility statute be clear on its face, and applied in a manner that is consistent with its purpose.

2. Foreign Tax Credit - Permanent Difference Items.

Background: As discussed above, current law assigns a taxpayer's items of foreign income to nine different income baskets: the first eight baskets address specific categories of income, and all remaining income is assigned to a "residual" or "general limitation" basket. Treasury regulations then allocate the foreign taxes incurred by the taxpayer to the different income baskets to which those relate.

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

The “financial services income” basket is intended to sweep within it all of the core business income of a financial services firm; for that reason, for example, interest or dividend income that would fall into the “passive income” basket of a manufacturing firm (or the general limitation basket, if subject to the high-tax kickout rule of section 904(d)(2)(A)(iii)(III)), instead is moved into the financial services income basket of a financial services firm.

For a manufacturing or typical services firm, the “general limitation” basket effectively is the base case: income from core business activities falls into that basket, and only in specific (and generally exceptional) cases does income fall into other baskets. For a financial services firm, by contrast, the financial services income basket is the base case, because that is where substantially all core business income falls, and the general limitation basket in fact holds only income derived from peripheral activities not connected with the firm’s core financial services business.

It sometimes is the case that a foreign jurisdiction will impose tax on amounts that are not (and never will be) income in a U.S. sense (a “permanent difference item”).⁴ Current Treasury regulations (§1.904-6(a)(1)(iv)) address this problem by arbitrarily assigning foreign taxes paid on a permanent difference item to the general limitation basket.

Proposal: The current rule makes sense for U.S. manufacturing firms, because the general limitation basket is the base case income basket for those companies. By putting foreign taxes on permanent difference items into the general limitation basket, the Treasury regulations make it more likely that U.S. manufacturing companies will eventually be able to credit those real foreign tax costs. This same rule penalizes financial services firms, however, because for the financial services industry the base case income basket is the financial services income basket, and only income (and taxes) from peripheral activities fall into the general limitation basket.

The SIA recommends that a statutory provision be adopted to recognize that the financial services income basket is the base case basket for financial services firms, and therefore to put otherwise unclassified foreign taxes on permanent difference items into this base case basket. It should be noted that the IRS considered and rejected this proposal in drafting the Treasury regulations described above. In the Preamble to those regulations, the IRS explained its rejection on the grounds that the problem we describe “rarely occurs.” Our response is twofold: First, the problem is not at all rare, but in fact arises as a result of many acquisitions and other commonplace transactions. Second, the relative rarity of an occurrence does not justify a clearly wrong answer.

3. Section 904(g) Reform.

⁴ For example, if a U.S. financial services company acquires a foreign target that holds a portfolio stock investment in a third company and the acquiror makes a section 338 election, the resulting step-up in the subsidiary’s tax bases in its assets will mean that the foreign subsidiary may not recognize gain on a subsequent resale of that portfolio stock investment for U.S. tax purposes, while recognizing gain (and incurring a real tax liability) under local law. The result is a permanent reduction in the subsidiary’s total income from a U.S. perspective, when compared to foreign law tax accounting norms.

Background: Section 904(g) is part of the regime for determining the source of income for purposes of section 904's limitations on the utilization of foreign tax credits. Section 904(g) currently provides as a general rule that income derived by a U.S. parent company from its foreign subsidiary (technically, from any "United States-owned foreign corporation") will be resourced from foreign-source income to U.S.-source income, to the extent that the foreign subsidiary in turn is treated as having earned that income from U.S. sources.⁵

When applied to foreign securities dealer subsidiaries of U.S. financial services firms, however, the resourcing rules of current section 904(g) inequitably limit the ability of U.S. securities firms to utilize U.S. tax credits for foreign taxes paid on income from their overseas securities dealing businesses. A securities dealer maintains and turns over a high volume of securities — either as securities held in its inventory for sale to customers, or as instruments to hedge the market risks on such inventory securities. As a consequence, securities dealers necessarily receive dividends and interest on their customer securities, even though such securities are not held for investment purposes. Dividends and interest payments generally are sourced for U.S. tax purposes according to the residence of the *payor* thereof.

All foreign securities dealer firms — whether subsidiaries of U.S. firms or not — that conduct business with foreign customers in U.S. dollar denominated securities necessarily hold many securities of U.S. issuers. For example, securities dealers throughout the world use U.S. Treasuries as hedging instruments. In addition, foreign securities dealer subsidiaries of U.S. firms generally compete in the global Eurobond markets, and as an integral part of that business, make markets in Eurobonds of U.S. issuers. (Eurobonds are instruments designed to be sold to investors located throughout the world, and are issued by companies from many jurisdictions, including the United States.) Thus, foreign subsidiaries of U.S. securities firms receive U.S.-source income in the ordinary course of their securities dealing businesses with *customers*, and moreover, *are subject to tax on such income* in the foreign jurisdictions in which they operate.

Proposal: The policy underlying the sourcing rules of section 904(g) is to prevent the resourcing of passive, mobile income derived from U.S. sources through the use of foreign subsidiaries. This policy concern, however, is not implicated in the case of dividends and interest income received on U.S. securities held by a U.S.-owned foreign securities dealer for purposes of conducting its securities dealing businesses with foreign customers. Such securities are held in the active conduct of a local customer business, and thus the dividend and interest income therefrom in the hands of a securities dealer is not of the passive type that can be controlled or manipulated.

Therefore, the SIA recommends that an amendment be made to section 904(g) to exclude from its scope income derived from a U.S.-owned foreign securities dealer

⁵ Thus, for example, if a U.S. corporation earns interest income from a U.S. Treasury held as an investment, that interest income is U.S. source. Section 904(g) provides that the result is the same (*i.e.*, U.S. source income) if the U.S. parent company causes a subsidiary to buy that U.S. Treasury as an investment, and then derives interest, dividend or subpart F income from its subsidiary attributable to the earnings on that U.S. Treasury.

subsidiary that is in turn derived from any security (as defined by section 475(c)(2), which includes physical securities and derivative instruments) held by a person in connection with its activities as a securities dealer (as defined by section 475(c)(1)).⁶

III. SECTION 956 - INVESTMENT IN UNITED STATES PROPERTY.

Section 956 of the Code is an anti-abuse measure that treats an investment by a foreign subsidiary of a U.S. parent company in “United States property,” such as stock or debt of a U.S. affiliate, as a deemed dividend for subpart F purposes, on the theory that such transactions economically are similar to a direct repatriation of the subsidiary’s earnings. In this regard, Congress has recognized in the past that certain exceptions to the definition of “United States property” are warranted to cover ordinary course business transactions entered into by foreign securities dealer affiliates of U.S. securities firms because such transactions do not violate the purpose of section 956.⁷ All of the issues described below relate to continuing technical problems in the mechanical application of current section 956 to U.S. securities firms, in contexts that do not implicate section 956’s policy agenda.

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

Background: “United States property” generally includes stock or debt of a foreign subsidiary’s U.S. parent (or any other U.S. affiliate). Currently, there is no exception to this general rule to cover the case of a foreign securities dealer subsidiary of a U.S. financial services firm that makes a market in the securities of a U.S. affiliate. Therefore, under current law, if a foreign securities dealer subsidiary of a U.S. financial services firm makes a market in the securities of a U.S. affiliate, the acquisition of such securities – even though acquired solely for sale to foreign customers in the ordinary course of the foreign subsidiary’s dealer business – is treated as an investment in “United States property,” and therefore as a deemed taxable repatriation of the foreign subsidiary’s earnings.

These ordinary course business transactions are commonplace for two basic reasons. First, U.S.-based multinational financial services groups are themselves multibillion dollar publicly-held enterprises, with substantial capital requirements that they satisfy, in part, by issuing securities to worldwide investors in the international capital markets. Second, the logical underwriter and market maker for each group’s securities is, of course, that group’s own securities dealer subsidiary with expertise in the relevant capital market. Thus, for example, if a U.S.-based multinational financial services group needs to raise long-term debt from international investors, the logical

⁶ A similar amendment was proposed by section 203 of the International Tax Simplification for American Competitiveness Bill (introduced in the 105th Congress, 2d session, as H.R. 4173).

⁷ The Taxpayer Relief Act of 1997 amended section 956 by adding two exceptions to cover ordinary course transactions entered into by foreign securities dealer affiliates of U.S. securities firms, *e.g.*, securities loans and sale-repurchase agreements. Under both types of transactions, collateral *equal in value* to the cash or securities loaned is required to be posted, as is the case in similar transactions with unrelated parties at arm’s length. See section 956(c)(2)(J) and section 956(c)(2)(K).

market in which to do so is the Eurobond market, which is based predominantly in London, and the logical underwriter to manage the issue and to make a secondary market in the securities is the group's London-based U.K. securities dealer subsidiary.

Proposal: On July 11, 2002, Chairman Bill Thomas of the House Ways and Means Committee introduced the "American Competitiveness and Corporate Accountability Act of 2002" (H.R. 5095, or the "Thomas Bill"). Section 322 of H.R. 5095 would add to the Code a new section 956(c)(2)(L), which would exclude from the definition of United States property any security issued by a U.S. affiliate held by a foreign dealer in securities, provided that (i) such securities are held primarily for sale to customers in the ordinary course of business, and (ii) the dealer in fact disposes of such securities within a period consistent with holding such securities for sale to customers in the ordinary course of business.

The SIA recommends that section 322 of H.R. 5095 be enacted as soon as possible. As noted above, the effect of current law is to provide a disincentive for U.S. financial services firms to use their own foreign subsidiaries to make markets in securities that the U.S. group issues to international investors. Section 322 is consistent with the policy underlying section 956, and also removes the incentive for U.S. companies to cede this business to their foreign-based competitors.

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

Background: Section 956(c)(2)(F) provides that United States property does not include the stock or obligation of an unrelated domestic corporation.⁸ There is no parallel exception to the definition of United States property for investments made in obligations of unrelated U.S. partnerships, trusts, estates, or individuals.

As a result, section 956 today applies beyond its intended scope, and also hinders the ordinary course overseas business activities of U.S.-based financial services firms. For example, it is common for U.S.-based institutional investment partnerships to acquire foreign securities from a foreign dealer affiliate of a U.S.-based financial services firm, where that foreign affiliate is the group's principal marketmaker in the foreign securities in question. The hedge fund's securities acquisition may be financed through a margin loan from the foreign subsidiary. The technical application of the current rules suggests that a margin loan to an unrelated U.S.-based institutional investment partnership would be treated as an investment in United States property, thus triggering the full effects of a deemed dividend pursuant to section 956. It is not appropriate for U.S. tax policy to prefer offshore investment funds to onshore ones, by placing barriers to domestic partnerships looking to finance purchases of foreign securities.

⁸ For example, a domestic corporation that "is neither a U.S. shareholder (as defined in section 951(b)) of the controlled foreign corporation, nor a domestic corporation, 25 percent or more of the total combined voting of which, immediately after the acquisition of any stock in such domestic corporation by the controlled foreign corporation, is owned, or is considered as being owned, by such United States shareholders in the aggregate;"

Proposal: Section 956 should be amended to provide for an exception from the definition of United States property for obligations of *unrelated* U.S. partnerships, trusts, estates and individuals.

IV. DOUBLE-TAX ISSUES PRIMARILY RELEVANT TO INTERNATIONALLY-OWNED FIRMS.

Earnings Stripping.

Background: Section 163(j) limits the ability of foreign-based multinationals to reduce the taxable income of their U.S. subsidiaries through the payment of interest expense to foreign affiliates (or to third parties in respect of debt that is guaranteed by foreign affiliates). Very generally, section 163(j) provides that a corporation whose debt-to-equity ratio exceeds 1.5-to-1 for a taxable year is denied a deduction for “disqualified interest” (*i.e.*, interest paid or accrued to a foreign affiliate that is not subject to tax on such interest, or in respect of debt that is guaranteed by a foreign affiliate if such interest is not subject to withholding tax) if and to the extent that the net interest expense of the corporation or branch exceeds 50 percent of the corporation’s adjusted taxable income.⁹ Any disallowed interest may be carried forward and utilized in subsequent years to the extent permitted under the section 163(j) limitation, and any “excess limitation” can be carried forward to increase allowable amounts in the succeeding three years.

Section 201 of H.R. 5095 proposed to significantly tighten the “earnings stripping” rules of section 163(j). H.R. 5095’s proposed changes would include: the debt-to-equity ratio safe harbor would be eliminated; disqualified interest would be permitted to reduce a maximum of 35 percent of adjusted taxable income, reduced from 50 percent; a new cap would be provided to the extent a U.S. subsidiary is more highly leveraged than the multinational’s worldwide group; the carryforward of disallowed interest would no longer be indefinite; and the three year carryforward of “excess limitation” would be eliminated.

Proposal: If enacted, section 201 of H.R. 5095 could have dramatic adverse consequences to the U.S. securities dealer affiliates of foreign banking institutions. Interest expense often represents the largest single category of tax deduction to a financial institution, and any distortion in the amount that the Code treats as deductible therefore can have enormous repercussions. As a result, any change to the tax rules in this area must be carefully considered and based on sound tax policy.

The Institute of International Bankers (the “IIB”) has recently provided extensive commentary regarding section 201 of H.R. 5095 and its consequences to foreign-owned banks and securities firms.¹⁰ The SIA believes that it is vitally important to a level

⁹ Adjusted taxable income is generally taxable income before deduction of net interest, net operating losses, depreciation or amortization; this is similar to a tax-EBITDA concept.

¹⁰ See *Banking Group Urges Exclusion from Amended Earnings Stripping Rules*, 2002 TAX NOTES TODAY 220-24 (November 14, 2002).

playing field for all securities firms doing business in the United States that the issues identified by the IIB be addressed in any earnings-stripping legislation.

V. DOUBLE-TAX ISSUES PRIMARILY RELEVANT TO DOMESTIC-OWNED FIRMS.

Global Dealing Operations/Dividends-Received Deduction.

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

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

- U.S. net-basis taxation of trading profits attributable to the U.S. branch of the foreign subsidiary;
- Foreign net-based taxation of the global income of the foreign subsidiary;
- U.S. branch taxes (including the branch level tax on “excess interest” and the tax on the “dividend equivalent amount”); and
- U.S. taxation of dividend income when the foreign subsidiary pays an actual dividend to its U.S. parent corporation – even when the dividend is attributable to “effectively connected income” (“ECI”) and a U.S. corporate tax has been previously paid – with no credit or other relief for any foreign withholding tax paid to the foreign subsidiary’s home country.

Proposal: The SIA is optimistic that in due course final Treasury regulations will develop a rational regime to allocate and source income from global dealing operations, thereby reducing the instances in which the IRS asserts that a global dealing operation gives rise to an inadvertent deemed U.S. branch. In the meantime, however, it is appropriate to address the possibility of multiple layers of taxation of the same income, in both actual and deemed branch cases. We therefore suggest the following three legislative actions to relieve a U.S. securities firm engaged in a global dealing operation from suffering triple taxation of income:

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

VI. ISSUES THAT ARE NOT SECURITIES INDUSTRY-SPECIFIC.

The large U.S. securities firms are all major multinational taxpayers. In addition to the industry-specific issues summarized above, multinational U.S.-based securities firms face many of the same international tax problems as do other U.S. industries. The SIA believes that the international tax provisions included in H.R. 5095 (subject to the needed industry-specific revisions summarized above) represent a significant improvement to the U.S. international tax system. We mention the following as being particularly important:

1. Foreign Tax Credit Baskets.

Background: Section 904(d) limits the ability of a U.S. taxpayer to utilize its foreign tax credits. Section 904(d) essentially serves two purposes: to limit foreign tax credits to the U.S. effective tax rate on that foreign income, and to limit a taxpayer’s ability to “cross credit” foreign taxes to cases where individual items of foreign income and associated foreign tax are all of the same general nature. Section 904(d) implements this “cross crediting” limitation by assigning a taxpayer’s items of foreign income into nine different income “baskets.”¹¹ The current number of nine baskets adds significant complexity to an already complex foreign tax credit system, and by disallowing tax credits in respect of foreign income taxes incurred in the ordinary course of an international business, often lead to the double taxation of income.

Proposal: The SIA recommends that the number of foreign tax credit limitation baskets be reduced to three: passive income, financial services income, and “general basket” income. This proposal is consistent with the approach recommended by the

¹¹ Current law provides for the following nine baskets: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from a noncontrolled section 902 foreign corporation (a “10/50 company”), (6) certain dividends from domestic international sales corporation or former domestic international sales corporation, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation or former sales corporation, and (9) and other income not described in items (1) through (8).

National Foreign Trade Council,¹² and also section 313 of H.R. 5095. In addition, the financial services basket should be updated in some technical respects to reflect the continuing evolution of the financial services markets.

2. Other Important Issues.

The SIA endorses section 302 of H.R. 5095, which would broaden the scope of the exceptions to “foreign personal holding company income,” by excluding all income (*i.e.*, dividends, interest, rents and royalties) from related corporations to a CFC (regardless of whether they are both organized in the same country) to the extent that the income is attributable to active business income, and not attributable to subpart F income such as portfolio interest or dividends. Section 302 would expand the overly restrictive current “same country” rules.

For example, current law requires that a minimum percentage of the payor’s assets be located in its country of organization in order for dividends and interest paid from a second-tier foreign subsidiary to its first-tier subsidiary in the same country be exempt from foreign personal holding company income. In the European Union, however, the Investment Services Directive and other regulatory guidance effectively encourages financial services firms to operate throughout the European Union in branch form. As a result, a financial services firm that operates throughout the European Union in branch form may encounter difficulty in meeting the current “same country” standard. Section 302 of H.R. 5095 would solve this problem.

The SIA endorses section 314 of H.R. 5095, which would extend the period that a taxpayer may carryforward excess foreign tax credits from five to ten years. Section 314 is consistent with the approach recommended by the National Foreign Trade Council.¹³

The SIA endorses section 316 of H.R. 5095, which, consistent with the reduction of the number of foreign tax credit baskets to three, would apply a look-through approach to dividends paid by so-called “10/50 corporations,” regardless of the year in which the relevant earnings and profits were accumulated.

The SIA endorses section 324 of H.R. 5095, which would allow taxpayers to elect to translate foreign income tax payments into U.S. dollar amounts using the exchange rates available as of the time such taxes are paid, as opposed to the general current rule requiring translation of tax payments using an average exchange rate. This election would only be available to the extent the foreign income taxes are denominated in a currency other than the taxpayer’s functional currency. In addition, a taxpayer may revoke such an election only with the consent of the Secretary.

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¹² *The NFTC Foreign Income Project: International Tax Policy for the 21st Century, Conclusions and Recommendations*, National Foreign Trade Council, Inc., Washington D.C., December 15, 2001.

¹³ *Id.*

Thank you for your long-term commitment to improving our nation's international tax rules, and for your consideration of our views. We would welcome the opportunity to discuss the issues outlined above at the appropriate time and, if it would be helpful, to elaborate in writing on any of the proposals. Please contact me (at 202-326-5324) if we can be of assistance in any way.

Sincerely,

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