sifma
Invested in America

August 7, 2017

The Honorable Steven Mnuchin
Secretary of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

RE: SIFMA Response to Notice 2017-38

Dear Secretary Mnuchin:

The Securities Industry and Financial Markets Association (SIFMA)[1] appreciates the opportunity to provide comments with respect to Notice 2017-38 which lists significant tax regulations pursuant to Executive Order 13789. The last section of Notice 2017-38 invites comments with respect to the regulations listed.

We applaud the Treasury Department for listing the regulations under Section 385 (T.D. 9790) and Section 367 (T.D. 9803) in your initial report, as SIFMA recommended in our letter dated June 2nd, as well as the regulations under Section 987 (T.D. 9794), and we urge you to consider the actions recommended below to reduce the regulatory burden and complexity for taxpayers. In addition, we greatly appreciate Treasury's recent announcement in Notice 2017-36, stating Treasury's decision to delay the effective date for the documentation rules in Treas. Reg. Sec. 1.385-2 until January 1, 2019. This additional delay will ease the compliance burden, nevertheless SIFMA continues to believe these rules should be withdrawn or substantially modified for the reasons explained further below.

I. IRC Section 385 Regulations

Final Section 385 regulations (T.D. 9790) were published in the Federal Register on October 21, 2016. SIFMA filed a detailed comment letter on the impact of the Section 385 regulations on the financial services industry when the rules were in proposed form.[2] While Treasury made numerous changes to the rules that we believe were

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[1] SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over $2.5 trillion for businesses and municipalities in the U.S., serving clients with over $18.5 trillion in assets and managing more than $67 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.
[2] Letter from SIFMA to the Hon. Mark Mazur Regarding IRS REG-108060 (Proposed Regulations Under Section 385), July 6, 2016 (http://www.sifma.org/issues/item.aspx?id=8589961304).

necessary to avoid some of the severe impacts on our member firms and the economy, there are a number of recommendations that we would still urge Treasury to adopt.

Enacted in 1969, Section 385 authorizes the Treasury Department to issue regulations setting forth factors to be taken into consideration when distinguishing between debt and equity in particular factual circumstances. Prior to 2016, no such regulations were in effect.

In April 2016 Treasury proposed a broad set of regulations under Section 385 that would recharacterize related party debt as equity in a wide variety of circumstances, a principal purpose of which was to prevent tax inversions and other tax-motivated transactions. In reality, the impact extended well beyond such purpose to ordinary course intercompany loans and payables that are central to the effective management and operation of liquidity and capital in any global financial service institution. The October 21, 2016 final regulations significantly narrowed the proposed rules as they apply to financial institutions in the context of certain transactions, particularly through the exemption provided to members of a "regulated financial group," but they retained the rule that recharacterizes related-party debt arrangements as equity if certain documentation requirements are not satisfied. No exemption or similar special consideration was given to the unique challenges and risks these rules would present to financial institutions.

Given that funding is the basic operating need of a financial institution, allowing it to serve its clients effectively, SIFMA members are impacted more severely than other industries. Our members must enter into a high volume of ordinary course intercompany funding transactions throughout their organizations to ensure that funding is continuously, rapidly and efficiently deployed to meet clients' needs at all times. Large global financial institutions can engage in thousands of intercompany funding transactions as frequently as daily and in amounts in the billions of dollars among hundreds of affiliates in the ordinary course of business. Such funding transactions can include simple loans for liquidity, normal trade payables for shared support services, collateral postings for derivatives or other types of transactions that are germane to the conduct of a financial services business. Recharacterization can occur under the final regulations long after intercompany debt transactions occur, complicating merger transactions, creating book and tax accounting mismatches, and introducing new regulatory and operating capital concerns for financial service companies.

SIFMA believes that the documentation rules, which now take effect January 1, 2019, create substantial economic and administrative burdens and operational risk for SIFMA members. While our members greatly appreciate the additional delay announced in Notice 2017-36, implementing such rules, even by the delayed effective date, will be extraordinarily difficult for our members. Given the complexity of their global operations, our members face an enormous task in terms of the time, effort and expense needed to develop and then maintain the additional systems, processes and procedures necessary to effectively administer, manage and control the high volume of intercompany funding that occurs with high frequency and regularity among the affiliates of a global financial institution. For example, the capability to perform credit analyses for affiliates receiving intercompany funding in support of documenting a reasonable expectation of repayment along with real-time monitoring of borrowing capacities would need to be newly built, a challenge compounded by the need to overhaul existing accounting or treasury infrastructure to produce the right sets of consolidated financial data that are mapped to the wide assortment of tested intercompany funding products would never have existed but for these regulations. Furthermore, even assuming the necessary time, effort and expense can be expended for implementation, it would be to achieve an end that is particularly counterproductive and counterintuitive to the very essence of the business of SIFMA members due to the severe constraints they would impose on their ability to continuously, rapidly and efficiently deploy funding to their affiliates, often in ways that are specifically mandated and governed by financial or prudential regulatory authorities. This would make it all the more difficult and potentially impossible to satisfy the documentation requirements without incurring other significant costs, such as having to raise and infuse additional capital and/or causing conflict with other regulatory requirements. In this manner, the documentation rules introduce a significant point of friction to the otherwise free flow of liquidity that is not only essential to the normal business activities of SIFMA members but to other vital objectives unique to our industry such as the preservation of resources to ensure the successful execution of resolution plans, maintenance of acceptable "double leverage" ratios that limit capital infusions into subsidiaries from borrowed proceeds, and adherence to the myriad of regulatory liquidity and capital minimums that may be prescribed for affiliates by applicable authorities.

The delayed effective date for the documentation rules does not resolve the serious concern that SIFMA shares with its members that the consequences of failing to meet the documentation requirements (e.g., loss of related interest deductions, creation of new classes of equity ownership) are overly harsh and out of proportion to the concern the Treasury Department has said the rule is intended to address. The preamble to the proposed regulation explained the rationale for enhanced documentation requirements as follows: "The absence of reasonable diligence by related-party lenders can have the effect of limiting the factual record that is available for additional scrutiny and thorough examination." 81 Fed. Reg. at 20915 (Apr. 8, 2016). We believe these objectives could be achieved by far less burdensome means.

SIFMA Position

Financial services firms have already diverted significant time, resource and capital away from other productive activities to ensure compliance with the documentation rules by their anticipated, earlier effective date of January 1, 2018, and they are continuing to do so despite Notice 2017-36, due to the seismic shift in business practices required by the regulations. For the reasons explained in detail above, SIFMA believes the one-year extension for compliance provided for in Notice 2017-36, while appreciated by our members, is still insufficient. In addition, SIFMA believes the general rule and the funding rule in the Section 385 regulations are overbroad and extremely complex. The limited nature of the exceptions to these rules, the breadth and complexity of the 72-month per se rule and the partnership rules, and other concerning features of the general rule and funding rule create severe compliance and tracking burdens for taxpayers. Accordingly, SIFMA respectfully requests that the Section 385 regulations be withdrawn immediately under E.O. 13789.

II. Section 367 Regulations

The final regulations under Section 367 (T.D. 9803) eliminated foreign goodwill and going concern value from property eligible for the active trade or business exception of Section 367(a)(3)(A).

Executive Order 13789 seeks to identify regulations that, inter alia, impose an undue financial burden on United States taxpayers or add undue complexity to federal tax laws. United States financial services companies operating foreign branches to serve local customers face an undue financial burden because the final regulations fail to take into account the unique circumstances of their operations that require them to operate in branch form and also could require them to reorganize branches into foreign subsidiaries for business and regulatory reasons. For example, the United Kingdom's exit from the European Union is forcing many global financial institutions to reorganize their operations to preserve European passporting rights. As it becomes more clear how financial institutions will operate within and outside of the United Kingdom, increased supervision and capital adequacy requirements may require branch structures to be incorporated.

Banks historically have operated in branch form for capital-efficiency reasons. Since the financial crisis, however, banking regulations and prudential oversight in general have changed, and regulators in some countries now prefer that foreign banks operate in subsidiary form in order to insulate the locally incorporated entity from liabilities arising in other branches in other parts of the world.

In the preamble to the September 2015 proposed regulations, Treasury and the IRS requested comments on whether "a limited exception should be provided for certain narrow cases where there is limited potential for abuse," offering an example of "a financial services business that operates in *true branch form* and for which there is *regulatory pressure or compulsion* to incorporate the assets of the branch in a foreign corporation." The legislative history and overall purpose of IRC Section 367(d) support the view that goodwill and going concern value developed by a foreign branch was not an area of concern when Congress enacted this legislation. Treasury understood this context and intent when it drafted the proposed regulations, and this is illustrated by the above request for comments in the 2015 preamble.

In the final regulations, however, Treasury explained that it believed this exception for branches clearly contemplated by Congress would be overly burdensome for the IRS to administer. This rationale is one-sided and contrary to the Congressional intent reflected in the statute's legislative history. Any burden imposed on the government to implement an exception for true branches is far outweighed by the financial burden and the significant inefficiencies that would be imposed on financial services businesses if an exception is not provided.

SIFMA Position

We respectfully request that Treasury defer to Congressional intent and modify the final regulations to provide for an exception at least insofar as it applies to U.S. financial services companies with foreign branches. The exception should include full or partial incorporations of regulated bank branches that meet certain standards. Such an exception is appropriate and we believe would be easily administrable. Without such a rule, these regulations will cause material negative consequences to U.S. financial services companies that are not the target of the Treasury Department or Congress in its efforts to address abusive cross-border transactions involving intangibles.

III. Section 987 Regulations

In December 2016, final and temporary regulations were issued under Section 987 which required taxpayers in the financial services industry to use a detailed and burdensome calculation methodology to determine currency gains or losses of its qualified business units. This was a significant departure from the 2006 proposed regulations, which fully exempted the financial services industry from that methodology.[3] As commentators have noted, the rules are extraordinarily complex and would impose a significant administrative burden on taxpayers.

In addition to the imposition of complex rules and the resulting administrative burden on taxpayers, the transition rules included in the regulations can result in a disallowance of built-in economic foreign exchange losses for certain taxpayers. For the financial services industry the transition rules are even more burdensome because they impose a retroactive application of the Section 987 rules to prior years. A retroactive application will require data that may not be available because the financial services industry was previously exempt from the application of the proposed Section 987 regulations. Moreover, the transition rules make little policy sense for the financial services industry because, in general, the assets of financial services companies churn frequently and are predominately fungible monetary assets.

Assuming financial services are exempted from the regulations, Treasury should provide a calculation methodology for all taxpayers that is more closely aligned with

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[3] The 2006 proposed regulations (REG-208270-86) provided that those regulations did not apply to "banks, insurance companies and similar financial entities . . ." *See* Treas. Reg. 1.987-1(b)(iii) of the 2006 proposed regulations. The final regulations, however, exempt banks (reference to "similar financial entities" is dropped in the final regulations). *See* Treas. Reg. 1.987-1(b)(ii) of the final 2016 regulations.

U.S. generally accepted accounting principles (GAAP), with warranted divergences on an ad hoc basis. For example, ad hoc adjustments could be made to reverse the U.S. GAAP foreign exchange movement on non-monetary assets for Section 987 purposes.[4] Such a methodology would be relatively easy to implement. Also, such a methodology would be materially accurate for financial services companies given that the assets of such companies are predominately monetary assets, which would be considered "marked" assets for purposes of the final Section 987 regulations.

SIFMA Position

SIFMA urges Treasury to exempt financial services companies and their affiliates from the application of the final Section 987 regulations and the related transition rules, for example by providing the regulations do not apply to 'financial services entities' within the meaning of Treas. Reg. 1.904-4(e)(3).[5] In addition, SIFMA recommends that Treasury should allow taxpayers to adopt a calculation methodology that is closely aligned with U.S. GAAP while allowing for ad hoc adjustments to account for foreign exchange movement on material non-monetary assets.

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SIFMA would welcome an opportunity to help explore options as you complete your subsequent report on the regulations listed in your response to Executive Order 13789, and should you have any questions please feel free to contact me at ppeabody@sifma.org or 202-962-7300. Thank you for your consideration of SIFMA's views.

Sincerely,

Payson R Peabody

Payson Peabody
Managing Director & Tax Counsel
SIFMA

[4] For instance, US GAAP foreign exchange movement on intangible assets could be subtracted from US GAAP currency translation adjustment, and then the net amount can be added to the earnings and profits of a controlled foreign corporation (CFC) or taxable income of a domestic entity, as the case may be.

[5] If the government doesn't want to fully exempt the financial services industry, then the IRS or Treasury should provide guidance (e.g., in form of a Notice) to clarify precisely what is meant by the term "banks" for this purpose. Note the contrast between the Section 987 regulation's exclusion for banks and the highly detailed exclusion for banks in the Section 385 regulations.

cc: David Kautter, Assistant Secretary for Tax Policy
Brian Callanan, Acting General Counsel, U.S. Treasury
Dan Kowalski, Counselor to the Secretary,
Justin Muzinich, Counselor to the Secretary,
Neomi Rao, Administrator, Office of Information and Regulatory Affairs,
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