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SIFMA VIEWS ON TAX REFORM

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

April 15, 2013

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Preamble

The Securities Industry and Financial Markets Association (SIFMA).

SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. Our mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. With offices in New York and Washington, D.C., SIFMA is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.

SIFMA Committed to Tax Reform

SIFMA is committed to helping the Ways & Means Committee to reform the Internal Revenue Code, and we are pleased to offer comments to the Committee on tax reform issues of interest to SIFMA members. We look forward to working with the Committee to achieve its objectives in tax reform by providing expert advice and the perspective of the financial services industry on matters before the Committee, including the manner in which tax policy proposals affects our members, their clients, and your constituents.

Overview

This document provides a high-level overview of SIFMA's positions on selected tax issues. It is not designed or intended to provide SIFMA's views on all of the many tax issues that concern our members. If you would like to discuss any issue not presented here, we encourage you to contact us directly. All of the information in this document is current as of April 15, 2013.

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Taxation of Financial Products.

SIFMA's comments on the Chairman's Financial Products Discussion Draft are contained in a separate letter to the Committee Chairman and ranking member dated April 15, 2013.

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Financial Services Industry Considerations in Addressing the Tax Treatment of Debt and Equity.

Several tax reform plans, including the business tax reform framework released by the Obama Administration in early 2012 and the comprehensive income tax reform bill introduced by Sens. Ron Wyden (D-OR) and Dan Coates (R-IN) in the 112th Congress, incorporate proposals to limit the deductibility of business interest expense in order to help pay for reductions to the corporate tax rate. SIFMA opposes proposals to limit business interest expense deductibility. If such a proposal does move forward, however, it is imperative that any limitation be applied to net, rather than gross, interest expense.[1]

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

Some have argued that a limitation is necessary to address a bias in the U.S. tax system for debt over equity. However, we believe that any bias favoring debt in the current tax system is a product of many factors, and that if Congress genuinely wishes to adjust the balance of incentives for debt and equity, it should examine the rules on a far more comprehensive basis, rather than addressing only the deductibility of corporate 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 tax on corporate profits. If Congress chooses to change the relative incentives for debt and equity,

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

it should do so on a holistic basis, rather than simply taking a piecemeal approach to interest deductions.

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

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 banking committees, which are charged with the responsibility, and have the unique experience and perspective necessary for making these kinds of 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 regulators would be disruptive and stress a financial system in its nascent recovery.

- Second, while financial institutions may be highly leveraged, the amount of permissible leverage, and the cost of funds, vary

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, including 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 high amounts of leverage, and generate relatively low profit margins. Limiting deductions for interest expense would have counterproductive effects, including damaging the liquidity of the Treasury market and discourage 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 on labor costs for a retailer. The indiscriminate disallowance or deferral of deductions for interest expense would dramatically impact the orderly lending business operations of financial institutions.

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International Tax Reform.

Executive Summary

The United States is one of the only remaining countries that continues to tax its residents on income derived from the active conduct of a foreign business. Most of our trading partners have moved toward a dividend exemption system, under which business income earned by foreign subsidiaries is taxed primarily in the country where it is earned, and anti-base erosion regimes, usually called "CFC regimes," serve to protect the home country tax base. One of the most important issues in the current international tax reform debate is whether the United States should replace its current worldwide tax regime with a hybrid system that includes an exemption for all or most foreign subsidiary dividends. House Ways and Means Committee Chairman Dave Camp (R-MI) released a discussion draft embodying such a system in 2011, and Sen. Michael Enzi (R-WY), who is a member of the Senate Finance Committee, introduced his own version of such legislation in 2012.

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

Whatever approach Congress decides to adopt for international tax reform, active foreign financial services businesses must continue to qualify for the same treatment as other active foreign businesses: a full or partial exemption for dividends, if Congress decides to proceed with a dividend exemption system.

If Congress adopts a dividend exemption system, it will be important to provide transition rules that preserve the ability of taxpayers to make use of existing tax attributes, and a fair and sensible mechanism to eliminate the lockout effect. SIFMA believes that, if international tax reform includes a thin capitalization regime to protect against base erosion, that regime should apply to *net* interest expense (as defined below). In addition, tax reform should preserve the principle of the "look-thru" rules, under which the transfer of funds from one foreign subsidiary to another does not trigger tax costs for a U.S. parent company. Finally, Congress should make all of the rules permanent. Some of the most important provisions of the current system have been adopted on a time-limited basis, and renewed from year to year as part of "extenders" packages.

Design issues in developing a Dividend Exemption System

Identifying active business income: **general principles.** Congress has developed rigorous standards for identifying active financial businesses. If Congress decides to adopt a dividend exemption system, those standards should be used to identify income qualifying for a full or partial exemption from tax under that system. With respect to other industries, current law focuses on identifying passive income that does not qualify for favorable treatment; active income eligible for deferral is a residual category. The move to a dividend exemption system may make it desirable to shift this focus slightly, perhaps by supplementing existing rules for identifying "bad" passive income with criteria for identifying "good" active income. As discussed in more detail below, Congress has been through this exercise in the context of the financial services industry: the factors that it considered may provide a useful template for its consideration of other industries.

Key Considerations for Financial Services Businesses

We are *customer-facing* businesses. Our foreign operations must be physically located where our customers are located. In this respect, we are perhaps more similar to a global restaurant chain than to businesses that

can concentrate profits in a central hub. Unlike other multinational businesses, we don't have meaningful opportunities to transfer intangibles to low-tax jurisdictions, or to exploit significant transfer pricing opportunities. Instead, we need to maintain a substantial physical presence in the world's major financial centers. In order to be able to provide services to our customers, we need to be licensed and regulated in those centers.

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

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

Treatment of Financial Services Income

Congress has developed carefully-tailored rules for determining when foreign income derived by securities dealers, banks and other financial services businesses is sufficiently active to qualify for deferral, and thus an exemption from Subpart F. Those rules (sometimes referred to as the active financing exemption or "AFE") reflect Congress's recognition that: (i) the *businesses* conducted by financial services companies can be just as active as the businesses conducted by manufacturing, pharmaceutical or high-tech companies, but (ii) the *principles* used to distinguish active from passive income in the context of non-financial businesses don't work for financial services businesses. This is because of the residual approach described above, under which interest, dividends and gains derived 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. In effect, Congress has recognized that money is the stock in trade—the widgets—of an active financial business. The AFE rules are the most fully developed and rigorous tests applicable under Subpart F. The rules are designed to ensure that income is earned in the active conduct of a financial services business and include detailed requirements concerning nature of the business activities, the country where those activities are conducted and the location of customers. Transactions with U.S.-based customers do not qualify for the benefit of the AFE.

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

Interest Expense: 95% Exemption as a Proxy for Expense Disallowance

The Camp discussion draft as well as the Enzi bill would provide a dividend exemption for most—95%—but not all active foreign income. The 5% inclusion in U.S. taxable income, without any foreign tax credit for foreign taxes paid, represents a form of proxy tax on indirect costs, including interest expense, that are deemed to relate to foreign earnings. Many countries have adopted this approach, which SIFMA strongly supports. The following section discusses the reasons why formulary apportionment of indirect costs would be inappropriate, and why other countries that have adopted a dividend exemption system do not require such apportionment.

Interest Expense: Thin Capitalization

Some commentators have expressed concern that the adoption of a territorial system would enable taxpayers to exploit favorable mismatches by situating tax-deductible borrowings in the United States, and funding tax-exempt foreign operations with equity. The Camp discussion draft responds effectively to this concern by providing a thin capitalization rule under which tax deductions for *net* interest expense incurred by a U.S. company (that is to say, the amount by which payments of interest expense exceed receipts of interest income) would be disallowed to the extent that the company is deemed to have excessive leverage. The most important aspects of this proposal, from the perspective of financial services companies, are that (i) the proposal would apply to net rather than gross interest expense; and (ii) it does not involve the application of a formulary apportionment method, or a one-size-fits-all cap on the amount of permissible indebtedness. **These features are critically important to financial services companies.**

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. Our major trading partners have not adopted a formulary apportionment method, and instead use a net interest thin capitalization approach.

A rule that disallows deductions for interest expense (i) to the extent a taxpayer's debt-equity ratio exceeds an arbitrary ceiling; or (ii) through the use of an apportionment method that is based on gross interest expense 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 deeply flawed interest allocation rules under current law don't impose intolerable burdens on financial services companies because the rules allow interest expense to be deducted in full in the year in which it is incurred, without regard to whether the interest is allocable to U.S. or foreign source income.

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

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

- Second, the indiscriminate disallowance of deductions for interest expense would have severe consequences for low-risk (and low-margin) businesses that are important to the orderly functioning of the financial markets. If deductions are deferred or 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, low-margin businesses.

SIFMA strongly supports the Camp discussion draft's approach of determining whether a company is thinly capitalized by reference to the net amount of interest expense that actually is available for deduction (rather than gross interest expense before offset by interest income). We believe that this practical and thoughtful approach will do the job: it will effectively deter taxpayers from borrowing excessively in the United States to fund non-U.S. operations. A test based on net interest expense has the following additional advantages:

- It can be applied on a uniform basis to all industry groups, and should eliminate the need to consider whether different standards

should be applied to financial services companies, and if so what those standards should be; and

- It will be more fault-tolerant. In view of the severe business consequences of deferring or disallowing deductions for interest expense, it is strongly desirable to invoke the thin capitalization rule only in cases where a failure to do so would permit abuse. Applying the rule only to net interest expense should help to limit the potential for unfair and unintended consequences.

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. There are essentially two choices: (i) branch earnings could qualify for territorial treatment, under rules that recognize and take account of the fundamental differences between branches and subsidiaries; or (ii) branch earnings could be subject to taxation as 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 foreign branches. 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 a dividend 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 as part of the legislative process, and not to rely on a general grant of regulatory authority to deal with the tough issues afterwards.

Transition Issues

Treatment of pre-effective date foreign earnings. The Camp discussion draft would subject all pre-effective date retained foreign earnings to a one-time tax at an effective reduced rate of 5.25%. Senator Enzi's proposal would tax such earnings at a reduced rate upon repatriation, but unlike the Camp discussion draft would not require a

mandatory deemed repatriation. Either of these proposed approaches would reduce incentives under existing law to retain earnings outside the United States (the "lockout" effect described above), and would minimize the burdens associated with the need to apply two inconsistent bodies of rules, under old law and new law. SIFMA believes that further thought should be given to the best way to achieve these important objectives.

- The mandatory repatriation approach doesn't take account of the fact that companies have reinvested earnings outside the United States in reliance on current law, and may not have the liquidity to support an actual dividend corresponding to the distribution that they will be deemed to make. For example,
    - A foreign subsidiary of a U.S. pharmaceutical company may have used its retained earnings to build a production facility; and
    - A foreign subsidiary of a U.S. bank may have used its retained earnings to increase its regulatory capital. Regulatory capital is the equivalent, for a financial services company, of a bricks-and-mortar facility for a manufacturing company, and can be just as permanent, and just as difficult to convert into free cash available for distribution.
- If Congress elects to proceed with a deemed repatriation approach, the details of determining the amount subject to tax will be critically important. In particular, foreign earnings should be determined on an aggregate basis, netting the earnings and tax history of all of a U.S. company's foreign subsidiaries. Mandatory repatriation without such netting could produce severe distortions.

FTC and ODL carryovers should be preserved. Current law provides important safeguards to protect taxpayers from the loss of benefits for tax costs that they have actually incurred solely because of

timing differences that prevent them from using those benefits immediately. The most important of these rules in the international context are the ability to carry over excess foreign tax credits ("**FTCs**") and to resource domestic income to offset the detrimental consequences of overall domestic losses ("**ODLs**").

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

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

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.[2]) 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

[2] 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.

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 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.

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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.

Tax law with respect to the classification of workers has been a settled matter since 1978. Recently, competing legislative proposals have been introduced in Congress that would make significant changes to the law. One proposal, based on proposals put forth by the Obama Administration, would repeal the safe harbor that has been in effect since 1978, raising the prospect of serious disruption to the business model of many independent securities firms. The other, sponsored by Rep. Eric Paulsen (R-MN), a member of the Ways and Means Committee, would codify the long-time safe harbor, while adding an additional safe harbor

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.

While Congress has revisited this issue many times since the imposition of the moratorium, the current legislative proposals mark one of the most serious effort to change the law in many years. In the last Congress, former Senator John Kerry (D-MA), who has since become the U.S. Secretary of State, and Rep. Jim McDermott (D-WA) introduced identical bills to repeal the moratorium, including the safe harbor on long-standing industry practices, on the issuance of guidance by the IRS requiring the reclassification of workers. The bills are very similar to a proposal included in the Obama Administration budget. Both bills are titled "The Fair Playing Field Act of 2012" (S. 2145, HR 4123). The Senate bill had seven cosponsors, the House bill has 32 cosponsors in the 112th Congress – all were Democratic members.

The bills were identical to the legislation that Sen. Kerry and Rep. McDermott had introduced in the prior Congress, with one notable exception. The bills included a special provision relating to the status of broker-dealers. The language provides 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.

Toward the end of the last Congress, Rep. Erik Paulsen introduced a contrasting piece of legislation, H.R. 6653, the "Independent Contractor Tax Fairness and Simplification Act of 2012." The Paulsen bill would preserve the safe harbor that the Kerry-McDermott bill proposed to repeal, and also create a new safe harbor for determining employment status.

Senator Kerry's departure has left the bill without a Senate proponent, though we expect that another Senator could step forward to introduce the bill. In the House of Representatives, however, the Paulsen

proposal will provide the starting point for discussion. As Ways and Means Committee Chairman Dave Camp (R-MI) develops his tax reform draft proposal, there will be an opportunity to advance worker classification proposals that support the long-standing practices in the securities industry. SIFMA and individual member companies have worked closely with Rep. Paulsen's office on this issue, and will continue to monitor the issue to protect the interests of the many securities industry firms and their workers whose continued economic success depends on maintaining existing business models.

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Financial Transaction Tax (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. President Lyndon Johnson repealed the last federal stock transaction tax in the 1960s. SIFMA believes an FTT would raise the cost of capital desperately needed by businesses; it would be a sales tax on retirees and every day 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.

Today, most economists agree that an FTT would cause shifting of transactions to other markets, less liquidity, and a significant increase in the cost of capital that would cause slower growth and unemployment.

SIFMA was pleased to hear Treasury Secretary Jack Lew's comments on the recent European FTT proposal that SIFMA believes is extraterritorial during a House Ways and Means Committee hearing on the President's FY 2014 Budget. We agree with Secretary Lew's statement that "it is not acceptable policy from our perspective for other countries to create a tax that has an extraterritorial reach and would levy a tax on a transaction in the United States."[3] SIFMA looks forward to continuing to educate and work with members and staff on this issue.

[3] For reasons explained elsewhere in this document, SIFMA does not support a bank tax as an alternative to an FTT.

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SIFMA Advocacy Links
Comment Letters: • 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

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Retaining Tax Incentives for Retirement Savings.

SIFMA Supports Preserving the Current Retirement Savings Tax Incentives

- The current retirement system provides American employers with the opportunity to contribute to their employees' retirement security and American workers with cost-efficient opportunities to save for their future.
- Proposed reforms to the retirement system should focus on increasing participation by encouraging employers to start new plans and continue current plans, while working to strengthen the Social Security system.
- Tax rules governing employer-sponsored benefit plans and individual retirement accounts ("IRAs") already impose (a) reasonable limits on contributions to, and benefits under, these plans based on compensation, (b) dollar limitations on employee tax deferred contributions to plans and IRAs, and (c) effective limits on "excess" contributions to these accounts.
- Through these limits, Congress and multiple administrations have balanced tax expenditures with the critical need to increase savings for retirement, to take pressure off of Social Security, and to ensure a secure retirement with dignity for American workers.
- Imposing a new tax on total accumulations, in addition to these contribution limits, penalizes successful investment return for those employees that we have urged to save and invest wisely, and will discourage not only retirement savings, but savings generally.
- All of these assets are either taxed currently at regular income tax rates (in the case of Roth-type accounts) or taxable at regular income tax rates upon distributions; thus, giving employees an incentive to save for retirement only defers tax revenue.

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Tax Deductibility Encourages Saving; Tax Penalties on "Successful" Savings Discourage It

A March 2011 Employee Benefit Research Institute (EBRI) Retirement Confidence Survey shows that over 60 percent of respondents stated that the ability to deduct their retirement savings plan contributions from their taxable income is a very important factor in their decision to save for retirement. Over 76 percent of respondents in the lowest income category rated tax deductibility of contributions as very important. *A survey conducted by the Investment Company Institute shows that 72 percent of individuals disagreed that tax incentives for defined contribution accounts and IRAs should be reduced.*

Contrary to some European countries, the U.S. pension system is voluntary. To the extent that employers are required to limit contributions for their senior managers, they may reduce the percentage of compensation for all employees, causing a trickledown effect on the lower paid employees who are most in need of increased retirement savings. If contributions are limited for small business owners, many will discontinue their plans which would increase the number of employees who do not have access to employer-sponsored plans.

The Current Retirement System Encourages Retirement Savings

Eliminating or diminishing the current tax treatment of employer-provided retirement plans will jeopardize the retirement security of tens of millions of American workers, impact the role of retirement assets in the capital markets, and adversely affect the quality of life and income security of retirees, especially as Americans live longer.

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SIFMA Believes More Needs to Be Done to Encourage, Not Discourage, Savings

There is universal agreement that Americans need to save more for retirement. Americans need to invest smarter, with better understanding of the benefits of compounding interest, diversification, and preserving retirement savings accounts for retirement, and not making withdrawals for other purposes. Imposing arbitrary limits on savings, near the end of a worker's employment is a poorly conceived lottery, where the bet is that the markets won't suffer a correction when there is no more time to save.

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

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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 already seen some significant developments that have resulted in higher taxes for investors. The American Taxpayer Relief Act of 2012 (ATRA) signed into law on January 2, 2013, makes permanent the 15 percent 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 percent rate.

In addition, the Affordable Care Act (ACA), signed into law by President Obama on March 23, 2010, also applies 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 on January 1, 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.

SIFMA believes that should Congress consider 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.

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Federal Tax Exemption for Municipal Bond Interest.

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

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

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

Pressure to close the federal budget deficit and to broaden the tax base in order to offset a reduction in tax rates under tax reform is causing Congress to consider curtailing "tax expenditures," including the tax-exemption. For example, the Simpson-Bowles Commission report considered eliminating all tax-exempt bond issuance going forward. And, in its FY 2014 Budget, the Obama Administration proposed capping the value of many individual tax preferences, including the tax-exemption, at the 28-percent rate. While the cap proposal would nominally affect taxpayers in higher tax brackets, 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 the Administration's proposal is that it would apply not only to newly issued

or acquired bonds but also to outstanding bonds as well. Consequently, the negative effects of the proposal would extend to lower income investors through a reduction in the market value of their bonds. Also, the cap is inconsistent with other elements of the administration's FY 2014 budget which are designed to promote and lower the cost of infrastructure investment.

Other proposals favor the use of taxable bonds with interest subsidies from the federal government, similar to the now-expired authorization of Build America Bonds. However, unlike Build America Bonds, these new taxable bonds, such as the President's proposed America Fast Forward Bonds, would receive only a 28% subsidy. Given their recent experience with BAB subsidies, some issuers have expressed reservations about market acceptance of the President's new approach, because of the different characteristics of taxable investors.

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

In SIFMA's experience, tax credit bonds of the type where the credit accrues to investors have not achieved the level of market acceptance as traditional municipal bonds, so a wholesale transition to tax credit bonds would be risky for the market and for issuers. SIFMA is opposed to the Obama Administration's 28% cap proposal, and without more specific information about the income tax rate reductions that could be achieved, or whether existing issues would be allowed transition relief, SIFMA will oppose proposals to curtail the exclusion.

SIFMA Advocacy Links
Comment Letters: • SIFMA comment to House of Representatives dated Mar. 4, 2010

Bank Tax.

In early 2010, the Obama Administration proposed a new tax on financial institutions called the Financial Crisis Responsibility Fee. The proposal was designed to recover the net cost of the financial assistance provided to financial services institutions and other companies through the Troubled Asset Relief Program (TARP) and to encourage less risky behavior by financial institutions going forward. The Administration has included the Financial Crisis Responsibility Fee in its proposed budgets for the past two years and has included it again in the FY 2014 budget. In 2012, the Obama Administration more than doubled the amount it projects the fee would raise from $30 billion to $61 billion in order to offset the cost of a new program aimed at mortgage workouts and restructurings.

SIFMA opposes the Financial Crisis Responsibility Fee, or any other similar assessment targeted at financial institutions. The economy is still recovering from one of the nation's worst financial crises and business credit availability and demand remains low. Likewise, financial companies continue to raise capital, repair balance sheets, and prepare to comply with enhanced capital standards, additional fees and assessments as required by the Dodd-Frank Act. SIFMA believes the President's proposal is ill advised because it seeks to layer a new and poorly designed tax on financial institution balance sheets as a means of influencing behavior, on top of these regulatory reforms.

On February 2012, the Washington Post published an unsigned editorial opposing the bank tax as a punitive measure that would harm the public indirectly. Among the points raised in the Washington Post editorial was the recognition that it would be unfair to attribute remaining TARP costs to financial services firms, given the more broad uses of TARP funds outside the financial services sector. SIFMA agrees with this observation.

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SIFMA Advocacy Links
Comment Letters: • Joint trades comment to the House Majority and Minority Leaders dated September 16, 2010

Foreign Account Tax Compliance Act (FATCA).

The Hiring Incentives to Restore Employment (HIRE) Act of 2010 added a new Chapter 4 to the Internal Revenue Code, which expands the information reporting requirements imposed on foreign financial institutions (FFIs) in an effort to ensure that U.S. taxpayers are not avoiding U.S. tax through the use of offshore financial accounts. These rules are commonly referred to as the FATCA rules.

The FATCA provisions impose a 30 percent withholding tax on payments to an FFI of U.S.-source interest, dividends, rents, salaries, or gross proceeds from the sale of assets that produce U.S.-source income. The tax can be avoided, but only if the FFI enters into an agreement with the Treasury to comply with information reporting requirements with respect to U.S. accounts and the FFI agrees to withhold on certain payments to non-participating FFIs and "recalcitrant" individual account holders. Treasury has negotiated intergovernmental agreements (IGAs) that modify these rules and facilitate FFI compliance in participating IGA countries, and is continuing to expand the universe of such IGA countries. These agreements are expected to enable FATCA compliance by overcoming obstacles in local law that may prevent FFIs from entering into FATCA agreements with the IRS.

FATCA is a key component of the federal government's push for heightened tax compliance among U.S. taxpayers with foreign accounts and assets. FATCA was implemented to ensure that the U.S. government has the necessary tools effectively to determine the ownership of U.S. assets in foreign accounts. On January 17, 2013, the Treasury Department issued final regulations under FATCA.

FATCA generally became effective on January 1, 2013, and FFIs must sign agreements with the IRS by later this year in order to avoid withholding of U.S. source interest, dividends, and rents that will commence in January 2014.

FATCA is one of the most comprehensive statutes ever enacted to enhance compliance by Americans with U.S. tax laws through information reporting and withholding, with much of the burden for implementing the new law falling on U.S. and foreign financial services firms. Its requirements already have significantly impacted the systems and operations of both U.S. and non-U.S. companies. SIFMA members, at a cost of hundreds of millions of dollars, are currently making significant modifications to their internal systems, control frameworks, processes and procedures to prepare for the date FATCA withholding goes into effect.

SIFMA supports the objectives of FATCA to improve offshore tax compliance. SIFMA has submitted numerous rounds of comments to assist the Treasury and the IRS in crafting regulations that are effective in accomplishing FATCA's goals, are commercially viable, and will not unnecessarily disrupt the operations of the financial markets. Recently, SIFMA provided Treasury with extensive information about how various markets work in practice in order to facilitate the development of sound regulatory policies.

SIFMA will continue to work with the Treasury and IRS, and with members of Congress and their staffs to ensure that FATCA is implemented in a manner that achieves these objectives. Due to the very significant costs that US banks and their foreign counterparts are now incurring to implement FATCA, SIFMA does not believe this is the right time to consider expanding FATCA legislatively.

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SIFMA Advocacy Links
Comment Letters: • SIFMA comment to Treasury Department and IRS dated Nov. 21, 2012 • SIFMA comment to Treasury Department and IRS dated Oct. 8, 2012 • SIFMA comment to Treasury Department and IRS dated Apr. 30, 2012 • SIFMA comment to Treasury Department dated Apr. 30, 2012 • SIFMA comment to Treasury and IRS dated Oct. 3, 2011 • SIFMA comment to Treasury Department and IRS dated Jun. 7, 2011 **Testimony:** • SIFMA testimony before IRS dated May 15, 2012 • SIFMA written response before the HFSC dated Jun. 29, 2011

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Cost Basis Reporting.

Over the past decade, the Internal Revenue Service (IRS) has increasingly advanced legislative proposals that require financial services firms to report tax-relevant information to the IRS about its customers and trading partners as a means to increase voluntary tax compliance. The most significant of these proposals impacts the securities industry directly: a requirement to report the adjusted cost basis of securities purchased or transferred from another securities firm. SIFMA supports efforts to increase tax compliance and continually seeks provide services, like basis reporting, that customers value. However, given the significant operational challenges inherent in the rollout of cost basis tracking from simple assets, like stocks, to derivatives and debt instruments, SIFMA has asked for additional time to implement some of the more complex rules, consistent with the goal of improving tax compliance.

Enacted as part of the Emergency Economic Stabilization Act of 2008, and codified in Sections 6045 and 6045A of the Internal Revenue Code, the requirement for securities firms to report cost basis has been phased in by Treasury regulations, beginning in 2011 for stock transactions. The calculation and reporting of adjusted basis for derivatives and debt securities is considerably more complicated and SIFMA has been engaged with Treasury in recent months, both to comment on proposed regulations issued in November 2011 and to request a delay of proposed implementation dates, given the difficulty faced by tax preparers and our member firms complying with the new reporting rules. SIFMA has filed comments with respect to cost basis reporting on options and will comment in the near future on basis reporting for debt securities.

SIFMA Advocacy Links
Comment Letters: • SIFMA comment to the IRS dated Aug. 27, 2012 • SIFMA comment to the IRS dated Feb. 14, 2012 **Testimony:** • SIFMA testimony before the IRS dated Jan. 25, 2012