STATEMENT ON BEHALF OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

SUBMITTED FOR THE RECORD OF THE HEARING
ON

"HOW OTHER COUNTRIES HAVE USED TAX REFORM TO HELP THEIR COMPANIES COMPETE IN THE GLOBAL MARKET AND CREATE JOBS"

BEFORE

THE COMMITTEE ON WAYS AND MEANS

ON

MAY 24, 2011

Introduction

The Securities Industry and Financial Markets Association (SIFMA)[1] welcomes the opportunity to provide comments for the record on the May 24, 2011 Committee on Ways and Means ("Committee") hearing to "examine international tax rules in various countries with an eye toward identifying best practices that might be applied to international tax reform in the United States."[2] As the Committee examines the feasibility of adopting a dividend exemption system that would move the United States closer to a territorial tax structure, a critical design element is whether interest expense will be disallowed in calculating exempt dividend income. At this time, SIFMA is not prepared to make general recommendations as to the future direction of U.S international tax policy. As the Committee considers a dividend exemption system, however, we do have a view regarding the importance of heeding "lessons learned" by other countries that have adopted dividend exemption systems. In this regard, we urge the Committee to reject rules to allocate and disallow a portion of a company's global interest expense. A dividend exemption regime that includes interest allocation and disallowance would almost always result in financial businesses losing U.S. interest deductions regardless of whether U.S. borrowings have any relation to exempt foreign earnings.

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[1] SIFMA represents the shared interests of hundreds of securities firms, banks and asset managers, with the mission 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 http://www.sifma.org.

[2] http://waysandmeans.house.gov (Hearing Advisory: accessed 18 May 2011).

Additionally, and in view of the Committee's focus on "policy choices that maximize competitiveness and job creation,"[3] we would like to share a comparative analysis of how selected countries with dividend exemption systems have treated interest expense of financial services firms that are headquartered in those countries.[4]

U.S.-headquartered SIFMA members that are global financial services firms have a particular concern that some may view the interest allocation rules that were developed in the United States for the limited purpose of calculating allowable foreign tax credits as an appropriate basis for disallowing interest deductions related to exempt dividend income.[5] For this reason, SIFMA organized a working group of member firms to evaluate options for an alternative to the application of the U.S. interest allocation rules. As a first step, the SIFMA working group surveyed the rules addressing home country interest expense under dividend exemption systems in six countries. The survey covered France, Germany, Switzerland, and the United Kingdom ("UK") in Europe, and Japan and Australia in the Asian-Pacific area.

As explained more fully below, none of the six countries limit the deductibility of interest expense directly. Rather, three of the six use the indirect approach of reducing the percentage of exempt dividends by 5 percent as a proxy for allocating expenses to exempt dividend income; two of the countries do not use a proxy (although one of the two does disallow interest allocable to foreign permanent establishments if the company elects to treat the income of that branch as exempt); and one (Switzerland) reduces qualifying dividend income by a portion of the shareholder's interest expense for the year in which dividends are paid (so interest expense is fully deductible in years in which no exempt dividends are received).

While none of the countries have adopted rules for allocating home country interest expense to foreign exempt income, SIFMA found that the countries have adopted various special rules for addressing the potential that companies might over-leverage their home country activities to capitalize foreign subsidiaries, resulting in interest deductions in the home country that could potentially erode the home country revenue base. Even here, however, these countries recognize that interest incurred by financial services companies essentially represents the "cost of goods sold," and so their "thin capitalization" ("thin cap") or interest cap regimes are either generally

[3] *Id.*

[4] In conjunction with this hearing, the staff of the Joint Committee on Taxation published JCX 33-11, "Background and Selected Issues Related to the U.S. International Tax System and Systems that Exempt Foreign Business Income," which provides only a general overview of the exemption systems in selected countries.

[5] *Cf.* The proposal to defer deductions of interest expense related to income eligible for deferral under current law, included in the Administration's Budget for fiscal year 2012. *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals*, Department of the Treasury (February 2011) 40-41.

designed to have little impact on financial services firms, or include special provisions to exempt most financial services activities. Similarly, all the countries include rules to differentiate between interest income that might be passive, taxable income for industrial companies and active business income for financial services companies.

I. THE SELECTED DIVIDEND EXEMPTION REGIMES

Although the selected regimes differ in their details, they all provide an exemption from the home country's income tax for dividends derived from active business income, where such income is distributed by a controlled foreign corporation ("CFC") to a multinational corporation ("MNC") that is organized there or otherwise treated as resident. The next discussion summarizes the following: the scope of the exemptions provided; the extent to which interest expense allocation rules are used; limitations on the deductibility of interest expense (including the significance of non-tax financial regulatory rules); special rules for financial services firms; and any anti-avoidance provisions.

II. EXPENSE ALLOCATION RULES

As a proxy for disallowance of expenses such as interest, dividend income received by an MNC from its CFC is 95 percent exempt in France, Germany, and Japan; in Switzerland, the UK, and Australia, 100 percent of qualifying income is exempt. Although Switzerland does not have any interest disallowance rules, interest expense — and charges such as administrative expenses — have the potential to dilute the dividend exemption because a portion of a Swiss MNC's shareholder interest expense is deducted from gross dividend income to calculate "net qualifying dividend income." This rule only applies to expenses for the year in which qualifying dividends are paid, so interest expense is fully deductible in years in which dividends are not paid. In any case, a special rule for banks limits their reduction of qualifying dividends to two-thirds of financing costs.

In view of the 5 percent taxability of dividend income in France, Germany, and Japan, it is not surprising that these countries do not provide any special rules to disallow the deduction of interest expense by a resident MNC. The same is true of the UK, although it provides a 100 percent exemption without reduction for deemed expenses.[6] Australian results are similar to those in the UK; although a loss or expense that an Australian MNC incurs in deriving non-

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[6] The UK government recently reviewed its treatment of interest expense and concluded that there should be no significant changes to the UK's "competitive regime for interest," reflecting the fact that a territorial approach to interest expense relief would be complex and difficult to manage. Note the discussion in section IV below, however, about the UK's targeted anti-avoidance provisions aimed at restricting interest deductions in certain scenarios. HM Treasury, "Corporate Tax Reform – delivering a more competitive system," (November 2010), page 30.

taxable income generally does not qualify for a deduction, an MNC resident in Australia is entitled to a deduction for interest incurred in deriving exempt dividend income from foreign subsidiaries. In those countries in which 95 percent of foreign earnings is subject to exemption, a foreign tax credit is not allowed for the portion that is taxable in the home country, further indicating that the taxable portion really is acting as a proxy for disallowing domestic expenses that may be attributable to exempt income.

Similarly, capital gain on the sale of shares in foreign subsidiaries can qualify for the applicable exemption in France, Germany, the UK, Switzerland (in the case of pure holding companies), and Australia; Japan is the exception. Generally, where capital gain would be exempt, capital losses from the sale of shares are not deductible (as in Germany and France, for example).

III. LIMITATIONS

The SIFMA working group also examined whether the six countries apply debt or thin cap rules to MNCs headquartered in that country to protect the domestic tax base. The group found that the UK, France, Switzerland, and Australia have thin cap regimes. Germany uses a general interest expense limitation rule. The sixth country, Japan, uses thin cap rules to limit the deductibility of interest paid on related-party debt by Japanese subsidiaries of foreign MNCs (similar to the U.S. earnings stripping regime under I.R.C. §163(j)). Significantly, however, *all of these jurisdictions provide special rules to accommodate the fact that financial services firms are highly leveraged*. Finally, the group also considered whether the tax regimes rely in any way on financial regulatory rules to determine whether a financial services firm is over-leveraged in the home country relative to its foreign operations.

A. Germany's General Interest Expense Limitation

Under the German regime, interest expense remains fully deductible up to the amount of accrued or received interest income, and beyond that (*i.e.*, the remaining net interest expense) up to 30 percent of taxable EBITDA.[7] Germany's general interest expense limitation rule does not apply if, *inter alia*, the company belongs to a worldwide consolidated group and its ratio of equity to the total balance sheet at the end of the prior fiscal year is equal to or greater than that of the consolidated group (escape clause).[8] Also, disallowed net interest expense (excess net interest expense) can be carried forward indefinitely and deducted in later years as interest, in addition to a five-year excess EBITDA carry forward. Generally, a group of German companies that form a

[7] For completeness purposes it should be noted that, if interest expense is not subject to the general limitation rule, it may be subject to 25% add-back for trade tax purposes. The add-back for trade tax purposes is subject to a special relief rule, if the taxpayer is a bank or certain financial enterprise (e.g. registered leasing companies).

[8] An equity percentage of up to 2 percentage points below that of the group is acceptable.

tax-consolidated group (*organschaft)* that does not consolidate for accounting purposes with any other entities is excepted from the interest expense limitation rule (standalone exception).

Germany does not provide a special rule for financial services firms, but such firms, in general, would have sufficient interest income to offset interest expenses, and hence no particular relief rule is necessary.

B. "Thin Cap" Regimes

1. *General Rules*

The UK uses a "worldwide debt cap" regime that restricts interest deductions of a UK group where the UK net debt of the group exceeds 75 percent of the worldwide gross debt of the group. Effectively, the application of the worldwide debt cap regime is limited to interest paid on loans from a related party.[9] Additionally, the UK applies transfer pricing provisions that require arm's length interest rates for intra-group financing. It also has a targeted anti-avoidance provision that restricts tax deductions for interest expense incurred in respect of a loan whose purpose includes an unallowable/tax avoidance purpose or where there is "international arbitrage."

France also uses thin cap rules, but these rules can be avoided if the debt-to-equity ratio of borrowers corresponds to the shareholders' equity ratio of their groups. Application of the French rule is limited to interest paid on loans from a related party (generally determined by reference to 50 percent of the borrowing company's share capital) and debt that is (directly or indirectly) guaranteed by a related party. Where the French rule applies, the deductibility of arm's length interest expense is limited to the greater of the following three amounts:

- Interest on 1.5 times the borrower's net equity;
- 25 percent of net-adjusted income before tax; or
- Interest income received from related parties.

Nondeductible interest may be carried forward indefinitely and used against up to 25 percent of current income under the French rules.

Like the French regime, the Swiss federal thin cap rules are also limited to the interest expense on debt from related parties; however, the methodology differs. Essentially, the Swiss guidelines prescribe a specified percentage of assets that may be financed by debt from related parties, with percentage that vary depending on the asset type.

[9] If a UK group has no related party interest expense then the worldwide debt cap regime does not apply. If a UK group has disallowed interest expense pursuant to the worldwide debt cap regime, the group can choose what interest expense is disallowed, including interest expense paid to unrelated parties. However, the maximum amount of interest expense that may be disallowed is limited to the net interest expense paid by the UK group to related parties.

The Australian thin cap rules are aimed at ensuring that entities do not allocate an excessive amount of debt to their Australian operations. These rules are based on a concept of "maximum allowable debt"; an entity will not violate the thin cap requirement if its "adjusted average debt" does not exceed its "maximum allowable debt." This rule applies to both inbound and outbound companies. For Australian-based companies with investments and operations outside of Australia, there are three approaches to calculating the maximum allowable debt:

- *Safe harbor debt level.* Very broadly, this is calculated as 75 percent of the Australian group's assets, less non-debt liabilities.[10] Because the maximum allowable debt calculation excludes the value of controlled foreign entity equity, an Australian company will erode its thin capitalization (or be in breach) on a 1:1 basis where leverage is used to fund a foreign controlled entity.
- *Statutory arm's length debt level*. Broadly, this is the amount of debt capital (includes loans as well as equity instruments that satisfy the statutory debt test) that would be lent to an entity by an independent commercial lending institution, if the borrower and notional lender were dealing at arm's length in respect of the Australian business assets.
- *Worldwide capital amount*. Broadly, this rule allows the *entity to leverage its Australian* operations up to 120 percent of the actual leverage of its worldwide group.

An Australian group of which 90 percent of its assets are domestic and is not controlled by non-Australian entities is exempted from the Australian thin cap rules.

2. *Special rules for a financial services business*

The UK, France, Switzerland, and Australia provide special rules to take account of the leverage that is a necessary part of a financial services business:

- The UK worldwide debt cap regime does not apply to qualifying financial services groups; qualifying activities include lending, insurance activities, and relevant dealings in financial instruments, but not asset management related activities.
- The French thin capitalization rules do not apply to "credit" institutions (such as banks, financial companies, and other entities listed by the relevant regulator as a "credit establishment,") or to financing granted by a Treasury Finance Center company in the course of a group centralized treasury agreement (*i.e.*, centralized management of group treasury) or financial lease agreements.
- Under the Swiss thin cap guidelines, the maximum indebtedness for companies whose main purpose is a financial business activity is 6/7 of the company's assets.
- For Australian financial outbound investors (non-authorized deposit-taking institution or non-ADI), the *safe harbor debt level* is modified to permit a higher allowable debt level. Broadly, this calculation is based on a 20:1 debt-to-equity ratio; also, special

[10] Non-debt liabilities typically include provisions for employee entitlements, ordinary trade payables, accruals balances and other non-interest bearing liabilities

rules apply to a corporation that is authorized to carry on a banking business in Australia, based on regulatory requirements (described below in section 4).

3. The role of non-tax financial regulatory rules

Only Australia expressly relies on capital adequacy requirements prescribed by the Australian Prudential Regulation Authority in policing banks. None of the remaining five countries explicitly rely on financial regulatory rules to police over-leveraging; however, reference is made to regulatory regimes in Switzerland and Germany.

Although there is no set rule in Switzerland, if the thin cap rules are violated, Swiss tax authorities can grant an exception when it can be demonstrated that the requirements of regulatory capital are met. As noted above, although Germany's general interest expense limitation rule does not take regulatory capital requirements into consideration, the method for allocation of capital between branches and headquarters — which also aims to limit the maximum amount of interest expense deductible in Germany — is based on risk-weighted assets for regulatory purposes.

IV. GENERAL ANTI-AVOIDANCE RULES

Finally, the SIFMA working group looked at whether the tax regimes included any income-based rules designed to protect the domestic tax base (such as debt-to-equity ratio tests, active business income tests, or minimum levels of foreign taxation requirements that could result in current taxation by the home country). The group found that Switzerland is the only one of the six countries that has *not* adopted an income-based anti-avoidance provision. France and Germany exclude passive income unless such income is taxed at a prescribed minimum foreign tax rate (generally, less than 50 percent of the French rate that would apply and less than 25 percent in Germany). Japan's rule is somewhat more complex: The rule applicable to a "Tax Haven Company" applies to income of a more-than 50-percent-owned subsidiary that has a head office in a country where the effective tax rate is 20 percent or less. There is, however, an active business exception that applies where a Tax Haven Company's main business is to actively operate and manage its own business in its own jurisdiction. Both the UK and Australia[11] seek to

[11] Australia's CFC rules are in the process of reform and ongoing consultation is underway – the centerpiece for these reforms is the proposed active business exemption which is designed to ensure only passive income is attributed to Australian resident controllers. The exposure draft legislation was released on 17 February 2011. Given the scale, complexity and importance of these rules, further consultation is underway before it is to be introduced into Parliament. Under the proposed new rules, the existing listed country, active income test, and AFI subsidiary exemptions will be retained. Further, the proposed CFC rules do not attribute tainted service or sales income. Moreover, a CFC grouping rule is incorporated which, broadly, should exclude most CFC to CFC passive income such that only certain non-grouped passive income may be attributable.

identify profits that have been "artificially diverted" from the home country. The UK rules may apply where a company is resident outside of the UK, but is controlled from the UK and subject to a level of tax that is less than 75 percent of the applicable UK rate. The five anti-avoidance regimes operate to impose a current home country tax.

Importantly, France, Germany, Japan, Australia, and the UK provide rules that accommodate financial services:

- France. Under one of the several safe harbor provisions in French law, the anti-avoidance rules do not apply if the profits of the foreign entity are derived from an industrial or commercial activity effectively performed in the country of establishment (*e.g.*, banking and insurance services would qualify as commercial activities).
- Germany. The German CFC rules do not apply to foreign operations of banking institutions (both CFCs and branches) that have sufficient substance for carrying on banking business in a commercial manner and provided such business is not carried out predominantly (according to the German tax authorities not more than 50 percent) with German resident taxpayers holding ownership interest in such foreign operations or with parties that are related to such German residents.
- Japan. Even where the active business exception applies, certain types of passive income derived by a Tax Haven Company could be included in the Japanese parent company's income ("Passive Income Rule"). There is, however, an exception to the Passive Income Rule for "income derived from fundamental, essential and important activity." Although there is no specific definition of income that is eligible for this exception, SIFMA understands that interest on bonds derived by banks or securities dealers is likely to be excluded from the definition of passive income.
- The UK. The UK CFC rules contain specific provisions for financial services activities. In considering whether a financial service business constitutes an exempt business for UK CFC purposes, there are prescribed thresholds that must be satisfied. Such companies should not carry on investment business and greater than 50 percent of their receipts should be derived from non-connected or associated persons. There are further tests to be satisfied including that not more than 10 percent of gross trading receipts are from UK persons.
- Australia. There are special CFC rules relating to Australian financial institution subsidiaries carrying on financial intermediary business. In effect, these special rules can exempt certain income derived from what would usually be classified as tainted assets (such as swap contracts, debentures, trading in loans, bonds, stocks, bills of exchange and promissory notes, *etc*.).

CONCLUSION

SIFMA appreciates the efforts of the Committee in delving into the international tax rules of other countries, in striving to design a tax reform plan that strikes a balance between global competitiveness and preserving the tax base. Our member firms stand ready to assist members of the Committee and their staffs to gain a more detailed understanding of the significance of tax rules relating to interest expense of U.S.-headquartered SIFMA members that are global financial services firms. SIFMA and its members look forward to working with the Committee in developing positive policy options that may impact financial markets, economic growth and job creation.