

NATIONAL FOREIGN TRADE COUNCIL, INC.

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October 3, 2011

The Honorable Max Baucus
Chairman
Committee on Finance
United States Senate
Washington, DC 20510

The Honorable Orrin G. Hatch
Ranking Member
Committee on Finance
United States Senate
Washington, DC 20510

Re: Stop Tax Haven Abuse Act

Dear Senators Baucus and Hatch:

The NFTC, organized in 1914, is an association of some 300 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities, and we seek to foster tax policies that attract and retain investment and jobs in the U.S. and allow worldwide American companies to compete in the international business arena.

The NFTC fully supports legislative proposals that target abusive offshore tax avoidance in a way that does not adversely hinder the legitimate commercial operations of globally integrated U.S. businesses with active operations abroad. The NFTC believes that it is important for policymakers to carefully evaluate legislative proposals that are intended to combat offshore tax avoidance. Without careful evaluation, such proposals may in fact undermine the international competitiveness of U.S. businesses without achieving the desired goal of combating abusive offshore tax avoidance. In this regard, it is important for policymakers to understand the legitimate business reasons for the organization and structure of U.S. businesses competing around the world, and the unintended consequences of overly broad legislative proposals.

Accordingly, the NFTC urges the Senate to reject the "Stop Tax Haven Abuse Act of 2011" (S. 1346) introduced by Senator Carl Levin (D-MI) on July 12, 2011 (the "Levin bill")¹, as well as the "International Tax Competitiveness Act of 2011" (S. 1373) introduced by Senator John Rockefeller (D-WV) on July 14, 2011 (the "Rockefeller bill"). In particular, the provisions in the Levin bill and Rockefeller bill discussed below, which are intended to address offshore tax avoidance, would fail to address their stated goals and would instead raise the cost of the foreign operations of U.S. businesses, thereby curtailing their ability to maintain and expand U.S. operations and employment. These proposals raise significant practical and policy concerns.

¹ Representative Lloyd Doggett, D-Texas, introduced companion legislation to the Levin bill on July 27, 2011.

I. Country-by-Country Reporting (Levin bill, Sec. 201)

A. Description of Proposal

Section 201 of the Levin bill (the “CBCR Proposal”) would require multinational corporations registered with the Securities and Exchange Commission (“SEC”) to provide detailed information concerning their operations on a country-by-country basis to the investing public and other financial statement users as part of the corporation’s SEC filings. This information includes the approximate number of employees, total amount of sales and purchases involving related and third parties, total amount of financing arrangements with related and third parties, and the total amount of tax obligations and actual tax payments made, on a country-by-country basis.

The stated purpose² of the CBCR Proposal is to address perceived "offshore secrecy" involving multinational corporations. According to this claim, country-specific information would assist investors in analyzing companies, assist tax authorities addressing perceived international tax avoidance, and assist with efforts to combat financial fraud and government corruption. In a floor statement, Senator Levin said: "The lack of country-specific information... impedes efficient tax administration, leaving tax authorities unable to effectively analyze transfer pricing arrangements, foreign tax credits, business arrangements that attempt to play one country off another to avoid taxation, and illicit tactics to move profits to tax havens." In addition, the CBCR Proposal is based on the assumption that the information required to be disclosed is readily available and therefore compliance with the new reporting requirement would not be a burden on companies.

B. Principal Reasons Why the CBCR Proposal Should Be Rejected

1. Effective Enforcement Tools Already Exist

There is no offshore secrecy problem when it comes to U.S. multinational companies. Multinational corporations file IRS Forms 5471 that detail the operations of every one of their foreign subsidiaries including income statements and balance sheets. The intercompany transactions of these foreign subsidiaries are disclosed in significant detail on Schedules M of Forms 5471. In addition, for companies claiming a foreign tax credit, taxable income from foreign sources is reported to the IRS on a country-by-country basis, including associated foreign tax payments (Form 1118). The IRS can and does ask for even more information as part of its examinations. Thus, the U.S. government routinely receives substantial amounts of information about the non-U.S. activities of U.S. multinational groups.

For tax administrators in other countries, information about the operation of U.S. multinationals can be obtained through information sharing agreements and protocols that exist across multiple jurisdictions, including the United States. Every country has the right to request financial information as a part of its tax return examination and transfer pricing documentation processes, and both foreign and U.S. tax administrators can request the information covered by the CBCR Proposal.

² 2011 WTD 134-32 (July 12, 2011).

U.S. securities law should not be used to anticipate the financial information needed by other countries' tax administrators; other countries are fully entitled to request whatever data they need in administering their nation's tax laws. Multinational tax administration is not part of the SEC's mission. Moreover, it is difficult to see how making a company's proprietary information *publicly* available to persons lacking expertise in U.S or foreign tax law will aid tax administration. As noted below, the more likely result would be confusion among the investing public and reputational damage to fully compliant corporations.³

2. The Proposal Is Not An Effective Solution to Transfer Pricing Concerns

One of the stated purposes of the CBCR Proposal is to combat offshore tax avoidance through the use of inappropriate transfer pricing. However, supporters of the proposal have not shown that there is a transfer pricing problem that needs to be addressed, or explained how country-by-country reporting by SEC-registrants will enable tax authorities to improve transfer pricing administration. As noted above, the IRS receives a significant amount of information regarding U.S.-based multinationals' intercompany transactions (Schedule M of Form 5471) and non-U.S. tax authorities already can require taxpayers to provide any information relevant to the determination of appropriate transfer prices, including country-by-country reporting and documentation of the transfer pricing methods used for particular transactions. Moreover, *public* disclosure of the value of related party sales, purchases, and financings has no bearing on whether the prices charged among the related parties are reasonable and comply with the arm's-length standard under U.S. law.

Some non-governmental organizations (NGOs) have advocated use of global formulary apportionment and abandonment of the arm's-length standard that is the basis for OECD transfer pricing guidelines and is embodied in U.S. regulations and bilateral tax treaties. These NGOs favor country-by-country reporting because this information would be useful for determining transfer prices based on formulary apportionment principles. However, use of global formulary apportionment to allocate tax bases among countries is contrary to U.S. tax treaties and long-standing U.S. government and OECD policy; Congress should not assist NGOs that seek to undermine this policy.

The CBCR Proposal may encourage foreign countries to use formulary apportionment methods that are contrary to U.S. policy, which would result in additional controversies between U.S. and foreign tax authorities. Increased foreign assessments against U.S. multinationals would result in larger foreign tax credit claims, which may reduce U.S. tax revenues. This effectively would result in the U.S. subsidizing foreign jurisdictions that use country-by-country reporting to abrogate the arm's-length standard endorsed by both the U.S. and the OECD.

³ Concern about the detrimental effects of publicly disclosing confidential tax information is not a new issue. In 2002, it was suggested that corporate tax returns be made public. The Secretary of the Treasury, Paul H. O'Neill, responded that "...it is difficult to perceive how the general public would benefit from it. We have serious concerns that public disclosure of large corporate returns would cause considerable confusion amount the public and would subject corporations to misinformed, inexpert analyses of their finance and operating practices. Such confusion ...could significantly...damage that corporation's standing among investors." Letter of Treasury Secretary to Senator Grassley, August 16, 2002, 2002 TNT 196-18, Doc. 2002-22905.

3. Compliance With A New Reporting Requirement Will be Unduly Burdensome

The CBCR Proposal would require accumulation and public disclosure of information that is not currently required for either tax or financial statement purposes. As explained below, this proposal would require SEC registrants to create new information gathering and reporting systems, at a significant cost.

Due to differences in book and tax accounting⁴, the required country-by-country disclosures, if based on the financial statement accounting records, will not reflect the information reported in the local country tax returns. The CBCR Proposal will mandate the creation of a complex and exceedingly expensive information gathering system. The SEC annual filing required in the CBCR Proposal will require preparation of additional schedules and disclosures during a time period that was intended to be sufficient to prepare a single set of financial statements. Additionally, if the information requested must be audited by the company's independent auditors, this will result in additional costs. Subjecting SEC registrants to increased costs renders them less competitive in the global marketplace and makes the United States an increasingly less-desirable capital market.

We also believe the timing of disclosure under the CBCR Proposal may be too early for the SEC registrant to rely on existing information systems. The timing suggested for disclosure is consistent with filing of the required annual report to the SEC. However, most U.S. multinational corporations are not ready to file their income tax returns until several months after the financial accounts have been audited. Even if the local tax returns are based on the same financial year end, statutory audits generally take place after the financial audit is completed, and it would not be unusual for the statutory audit and the preparation of the tax returns to be completed well after the required SEC filing deadline. Accordingly, it may prove logistically impossible to comply with the disclosure deadlines proposed in the CBCR Proposal.

Finally, because of the numerous differences in how tax and financial statement data is accumulated and presented, we are very concerned that the CBCR Proposal's country-by-country information, when it is presented in conjunction with SEC financial statements, will likely create considerable confusions for the investing public. This point is discussed further below.

⁴ There are important differences between the information systems, processes and controls needed for SEC reporting and the systems needed to report tax information. With large multinational companies, the information required under U.S. GAAP or IFRS is very different from local statutory information on which most countries base their tax reporting. These differences may include differing taxable years where the local statutory tax year covers a different period from that which is used for financial accounting. Also, different accounting conventions may be used for local tax versus U.S. GAAP or IFRS. For example, local tax laws may require a cash basis of accounting, whereas financial statements generally are prepared on the accrual basis of accounting. Local countries may impose different sourcing rules for determining whether income or deductions are taken into account for local tax purposes, or may require separate calculations for routine deductions, such as depreciation. Annual tax payments may reflect carryforwards and carrybacks and settlements for prior years, which are not tracked in financial statement accounting systems. Local laws also may impose payments on differing bases than income, such as a tax on capital, a value added tax, extraction fees or operating concessions, all of which may have to be disclosed under the CBCR Proposal, but none of which are related to the income reported in the financial statements, nor tracked separately by financial statement information systems.

4. Companies Would Be Forced to Disclose Proprietary Information

The CBCR Proposal may severely impede the competitiveness of U.S. corporations by requiring public disclosure of confidential and proprietary company information. Foreign competitors may be able to reverse engineer the commercial strategies of the U.S. corporations based on the data disclosed under the CBCR Proposal. This would be detrimental to U.S. businesses, U.S. workers, and the U.S. economy. U.S. corporations are willing to be transparent with tax authorities but not their competitors.

There are many reasons why a company would wish to become an SEC registrant, and in some cases, a registrant may have minimal U.S. operations. If becoming an SEC registrant requires the type of information disclosures as included in the CBCR Proposal, many large multinational corporations may decide to de-list or list elsewhere in the world, and those companies that are SEC registrants will suffer a competitive disadvantage through disclosures that would benefit competitors.

5. The Proposal May Create Investor Confusion

The SEC was established by Congress to regulate the stock market and prevent corporate abuses relating to the offering and sale of securities and corporate reporting. To achieve its mandate, the SEC, through its rules, regulations and interpretations, sets reporting and disclosure requirements and then monitors and enforces them.

In setting reporting and disclosure rules, the SEC considers the type of information that will best assist investors in evaluating registrants' performance, understanding the risks related to particular registrants, and making sound decisions when investing in the capital markets. The CBCR Proposal may be disruptive to the SEC's purpose of serving investors in that it requires disclosures that the SEC has not determined are useful or relevant to investors. If Congress believes that existing SEC reporting standards are inadequate, it may request a study by the SEC to evaluate the value to investors of additional disclosures.

6. The Proposal Is Not An Effective Solution To Foreign Government Corruption

Country-by-country tax reporting has been advocated by NGOs as a way to curtail bribery and corruption in developing countries. However, country-by-country reporting limited to SEC registrants is of little value in holding foreign governments accountable for the collection and use of tax revenues. With only SEC registrants reporting, NGOs would not be able to match government revenues with expenditures and identify potential diversions of revenues, because non-SEC registrants and local domestic companies would not be required to report their payments to the foreign government. With only SEC -registrants reporting, there would be no valid benchmarks that NGOs could establish to identify disparities in tax payments. Moreover, disparities in tax payments are not a reliable indicator of foreign government corruption. Such disparities may be attributable to differing business models or profitability. For example, financial statement data for U.S. companies shows that there are large variations in effective tax rates even among companies within the same industry, which does not necessarily reflect tax evasion or avoidance.

Targeted multilateral measures are more effective in achieving the goals of NGOs. The OECD Anti-Bribery Convention establishes legally binding standards to criminalize bribery of foreign public officials in international business transactions and provides for a host of related measures that make this effective. The 34 OECD member countries and four non-member countries - Argentina, Brazil, Bulgaria, and South Africa - have adopted this Convention. The United States has implemented these standards in the Foreign Corrupt Practices Act. Another multilateral program, the Extractive Industries Transparency Initiative, provides a mechanism to match reports by government and extractive companies on receipts and payments of taxes related to oil, gas, and mining companies.

II. Treatment of Foreign Corporations Managed and Controlled in the United States as Domestic Corporations (Levin bill, Sec. 103; Rockefeller bill, Sec. 2)

A. Description of Proposal

Section 103 of the Levin bill and section 2 of the Rockefeller bill (the "Management and Control Proposal") would maintain the existing place-of-organization test for determining the tax residency of corporations organized under U.S. law. However, the tax residency of corporations organized under foreign law would dramatically change. In general, the Management and Control Proposal would apply to a foreign corporation that is either publicly traded, or has aggregate assets that equal or exceed \$50 million in value. Such foreign corporations would be taxed as U.S. corporations for U.S. federal income tax purposes if the "management and control" of the corporation occurs, directly or indirectly, primarily in the United States.

The Management and Control Proposal provides that a corporation's "management and control" will be considered to occur primarily in the United States if substantially all of the executive officers and senior management of the corporation who exercise day-to-day responsibility for making decisions involving strategic, financial, and operational policies of the corporation are located within the United States. To the extent individuals other than executive officers or senior management exercise such day-to-day responsibilities of a corporation, the Management and Control Proposal would treat such individuals as executive officers or senior management in determining whether the corporation is managed and controlled in the United States.

Limited exceptions from this treatment would apply. Notably, the Management and Control Proposal would not apply to a controlled foreign corporation ("CFC") of a U.S. corporation.

B. Principal Reasons Why the Management and Control Proposal Should Be Rejected

In a July 28, 2011, letter to the Senate Finance Committee, the Organization for International Investment ("OFII") raised valid and detailed concerns that the Management and Control Proposal would have broad and negative consequences for foreign-incorporated companies with U.S. operations, with negative repercussions for U.S. employment and the U.S. economy, as well as violate existing tax treaties.⁵ NFTC agrees with those comments, and also urges that the Management and Control Proposal be rejected.

1. The Proposal Would Create Uncertainty and Loss of U.S. Jobs

The Management and Control Proposal would replace an objective, easily understood and readily administrable test of corporate residency that has been a fundamental part of U.S. tax law since its inception, with a subjective, uncertain, and imprecise standard. The vague place of management and control test would significantly add to the complexity of U.S. tax law and materially increase tax controversy.

While there are other countries that use a management and control test, we are aware of no other country that employs a so-called place of management and control test that requires a detailed factual determination of the residency of a company based on the location of the day-to-day management of certain decision makers. The management and control test applied by some European countries -- an objective standard based on the location where the company's board of directors meetings are held -- is fundamentally different from the new and untested standard that would be applied under the Management and Control Proposal.

Replacing a longstanding and objective corporate residency test with an untested and subjective management and control test would discourage foreign-incorporated companies from locating executive and senior management in the United States. The potential tax costs of the deemed conversion of a foreign corporation into U.S. corporations could be severe, as the deemed domestic corporation would become subject to U.S. tax on all of its worldwide income, including foreign income earned directly and indirectly through foreign subsidiaries. Rather than risk being treated as a U.S. corporation, foreign-incorporated companies may view the removal of all top management from the United States as the only safe way to avoid the extensive and severe consequences of classification as a U.S. corporation.

Thus, the Management and Control Proposal would encourage the foreign parent to move top and regional management functions and activities away from the United States. This would have an obvious and negative impact on U.S. employment and the U.S. economy, at a crucial time when U.S. job growth is needed. The location of top management of a business unit will impact decisions regarding sources of supply, location of key support functions, and location of employees that could have a far reaching and adverse impact on the ability to retain or attract employees and activities in the United States. The loss of top management jobs may also mean the loss of high-paying jobs and support staff, as well as expenditures in research and marketing -- important jobs and activities that could be encouraged to move offshore under the Management and Control Proposal. Thus, we strongly believe the Management and Control Proposal should be rejected.

⁵ In addition, the Senate Finance Committee on September 8, 2011, held a hearing ("Tax Reform Options: International Issues") at which several witnesses testified against management and control legislation. In particular, the witnesses said the proposal would result in the loss of U.S. management and headquarter jobs.

2. The Proposal Would Conflict with U.S. Tax Treaties and Invite Retaliation From Other Countries

The Management and Control Proposal is particularly problematic when applied to corporations located in countries with which the United States has concluded tax treaties. The Management and Control Proposal would directly override 25 U.S. income tax treaties that resolve dual corporate residency in favor of the country in which the corporation is created or organized,⁶ and result in conflicts with other U.S. tax treaties that generally leave treaty eligibility for dual resident companies unresolved until the competent authorities can separately resolve the matter. Overriding U.S. international treaty obligations could also negatively impact the ability of the United States to negotiate and enter into new tax treaties with important trading partners.

NFTC is particularly concerned that a willingness on the part of the United States to enact laws that override its international agreements will invite retaliatory actions on the part of our treaty partners. If the United States were to adopt a policy of characterizing non-U.S. corporations as U.S. residents, other countries may consider enacting similar measures, the scope of which could be equal to or more adverse than the Management and Control Proposal. If one of our major treaty partners changed its definition of corporate residency in a similar manner as the Proposal, U.S. multinational corporations likely would have the same concerns that foreign-incorporated companies have with the Management and Control Proposal. Given these very real possibilities, NFTC opposes the Management and Control Proposal.

III. Tax on Earnings of Controlled Foreign Corporation Deposited in U.S. Financial Accounts (Levin bill, Sec. 106)

A. Description of Proposal

The United States generally does not tax certain active business profits earned abroad by a CFC until the CFC repatriates such profits to its U.S. parent company, usually in the form of a dividend. U.S. international tax rules explicitly prevent CFCs from effectively repatriating their foreign earnings through lending money or providing credit support to the U.S. parent by treating amounts that CFC invests in “United States property” (a defined term) as constructive distributions to the U.S. parent. The rationale for this treatment is that the U.S. parent has received an economic benefit from the CFC's investment as though the funds were distributed to the U.S. parent. “United States property” does not include deposits by CFCs in U.S. financial accounts or investments by CFCs in the stock or debt of unrelated U.S. companies.

Section 106 of the Levin bill (the "U.S. Investments Proposal") would treat funds deposited in U.S. financial accounts by CFCs as being repatriated to the United States. Specifically, funds that are deposited by, or on behalf of, a CFC to an account physically located in the United States would be treated as a constructive distribution by that foreign subsidiary to its U.S. parent.

⁶ The U.S. income tax treaties that would be overridden as a result of this tie-breaker rule are the treaties with Australia, Austria, Bangladesh, Barbados, Canada, Cyprus, Egypt, Greece, Hungary, Indonesia, Korea, Morocco, Norway, Pakistan, Philippines, Poland, Romania, Slovakia, Slovenia, South Africa, Sri Lanka, Sweden, Trinidad and Tobago, and Turkey.

B. Principal Reasons Why the U.S. Investments Proposal Should Be Rejected

1. This Exception to "United States Property" Is Not a "Loophole"

The stated purpose of the U.S. Investments Proposal is to close an unintended tax "loophole," but the exception for a CFC's U.S. bank deposits from the definition of "United States property" is not a loophole. Congress clearly contemplated that exception, and it has been a longstanding U.S. tax policy to encourage such deposits. The reason for excepting deposits in U.S. financial accounts is clear - such accounts do not economically benefit the U.S. parent company.

The relevant provisions were enacted in 1962, and CFCs have been permitted to make U.S. bank deposits since that time, notwithstanding legislative amendments and clarifying regulations. Importantly, in 1976, when the United States was struggling through an economic recession and high unemployment (as it is today), Congress expanded the exceptions to the definition of "United States property" by enacting the rule that allows a CFC to invest in the stock and debt of unrelated U.S. companies without the U.S. parent being taxed on the CFC's earnings.⁷

2. The Proposal Would Divert Investment from the U.S. Economy

The core assumption of the U.S. Investments Proposal (clearly expressed by Senator Levin in his floor statement) is that U.S. dollar investments and U.S. government obligations are the only choice for a prudent treasurer of a CFC. Accordingly, Senator Levin appears to believe that taxing a U.S. parent company on its CFC's cash deposits with a U.S. bank or investments in U.S. Treasury bonds (held through a U.S. bank) would not discourage such investments. In this global economy, however, CFCs have many attractive investment choices outside the United States. It is highly probable that the U.S. Investments Proposal would cause CFCs to stop investing in the U.S. economy. CFCs would divert their existing U.S. bank deposits into non-U.S. banks, without creating any correspondent accounts with U.S. banks, and divert their investments in U.S. securities (including U.S. government securities) into other highly-rated foreign sovereign debt or highly-rated foreign corporate securities.⁸

In enacting the 1976 expansion of the exceptions to "United States property," Congress expressed its awareness of how significant CFC funds invested in the United States are for the U.S. economy. The Senate Report⁹ for that legislation states that:

⁷ IRC section 956(c)(2)(F).

⁸ The rating of U.S. government debt has recently been downgraded from the highest credit rating available by one of the three agencies that rate sovereign debt obligations. The obligations of Australia, Austria, Canada, Denmark, Finland, France, Germany, Guernsey, Hong Kong, Isle of Man, Liechtenstein, Luxembourg, Netherlands, New Zealand, Norway, Singapore, Sweden, Switzerland, and United Kingdom currently enjoy the highest possible credit rating.

⁹ See S. Rept. 94-938 at 226 (1976), reprinted in 1976 U.S.C.C.A.N. 3438, 3656.

[treating investments in securities of unrelated U.S. companies as distributions to U.S. parent] may, in fact, have a detrimental effect upon our balance of payments by encouraging foreign corporations to invest their profits abroad. For example, a controlled foreign corporation looking for a temporary investment for its working capital is, by this provision, induced to purchase foreign rather than U.S. obligations. In the committee's view a provision which acts to encourage, rather than prevent, the accumulation of funds offshore should be altered to minimize any harmful balance of payments impact while not permitting the U.S. shareholders to use the earnings of controlled foreign corporations without payment of tax. . . . The classification of other investments in stock or debt of [unrelated] domestic corporations as the equivalent of dividends is, in the committee's view, detrimental to the promotion of investments in the United States.

CFCs use global U.S. banks to support their operating networks and keep on deposit their cash and working capital in the form of U.S. government obligations and securities of unrelated U.S. companies. Cash deposits flow into the U.S. economy as liquid funds available for lending by U.S. banks to U.S. businesses and consumers. If a CFC invests in U.S. Treasury bonds, that money flows to the U.S. government. Investments in securities of unrelated U.S. companies make capital available to such companies and generally support the liquidity and stability of the U.S. economy.

The U.S. Investments Proposal might result in a significant drain of liquid funds and capital from the U.S. economy. A contraction in U.S. banks' core deposit base would affect the ability of those banks to lend in the United States. At a time of fragile recovery from one of the worst recessions in history, the possible loss of liquidity and capital could have an adverse impact on the U.S. economy. When the U.S. economy needs as much liquidity and capital as possible to encourage further economic recovery, it should go without saying that the enactment of a law that potentially results in a flight of foreign investments should be avoided at all costs.

IV. Expanding Foreign Account Tax Compliance Act (FATCA) (Levin bill, Sec. 102)

A. Description of Proposal

FATCA was enacted in 2010 to assist the IRS in detecting potential U.S. tax evasion. It requires foreign financial institutions, including investment funds and insurance companies, to enter into agreements with the IRS to provide information on their U.S.-owned accounts or be subject to a 30 percent withholding tax on a broad range of U.S. source payments received by such financial institutions (including gross receipts from the disposition of U.S. securities). It also requires non-financial foreign entities to disclose (to withholding agents) details of any substantial U.S. owners of the entities, or face similar potentially punitive withholding taxes.

Section 102 of the Levin bill (the "FATCA Proposal") would expand FATCA by: (1) limiting the discretion granted to the Secretary of Treasury to mitigate FATCA's potential adverse impact on international trade and the global economy, (2) expanding its coverage, and (3) introducing presumptions that any U.S. person (other than a publicly traded entity) that has transactions with an entity (other than a publicly traded entity) that holds an account, or in any other manner, has assets in an institution that is not FATCA-compliant (i) exercised control

over such entity, and (ii) that any amount or thing of value received by such U.S. person from that entity is taxable income to the U.S. person.

B. Principal Reasons Why the Proposal Should Be Rejected

1. The Proposal Would Have a Negative Effect On International Commerce and Foreign Investment In the United States

The sweeping extra-territorial reach of FATCA gives it the potential to impose disproportionate and excessive burdens, not on the U.S. tax evaders (for which it was intended), but on the foreign financial institutions that have, in essence, been deputized to assist in the detection of U.S. tax evasion. Congress recognized these potential excessive burdens and their harmful effect on the global economy. As a result, the FATCA legislation gives extensive authority to the Secretary of the Treasury to balance these burdens and their impacts on the global economy against the goal of detecting U.S. tax evasion. The FATCA Proposal removes the Secretary of the Treasury's discretion to implement FATCA in a way that takes into account its potentially severe impact on our trading partners and may have a chilling effect on international commerce. In order for FATCA to be successful, it is crucial that foreign financial institutions opt into FATCA (rather than deciding not to comply and divesting from U.S. assets). This can only be achieved by drafting rules that balance the policy concerns of detecting potential U.S. tax evasion with the burdens placed on foreign financial institutions. It has been estimated that the largest foreign financial institutions could face costs as high as \$80 million to \$250 million to implement FATCA.¹⁰ Expanding the reporting requirements of an already onerous reporting regime will tip the balance away from encouraging foreign financial institutions to comply with FATCA. Those financial institutions that opt out of FATCA will be forced to substantially reduce or eliminate their U.S. investments in order to avoid punitive U.S. withholding taxes.

FATCA's extraordinary complexity has to date also prevented Treasury and the IRS from providing comprehensive guidance regarding how it will be implemented. While the FACTA Proposal purports to clarify when foreign financial accounts must be reported to the IRS, it will instead create greater uncertainty regarding how to apply FATCA and will impede Treasury's and the IRS's effort to publish comprehensive proposed FATCA regulations by the end of 2011. The Proposal significantly broadens legislation that has already engendered a broad, global, negative reaction. Expanding FATCA, especially through the FACTA Proposal's harsh presumption rules, would set a precedent for foreign countries to impose comparable sweeping and intrusive retaliatory legislation impacting U.S. financial institutions and non-financial companies.

2. The Proposal's Presumption Rules Will Negatively Impact Virtually Every Non-Publicly Traded U.S. Enterprise Doing Business Abroad

The FATCA Proposal's presumption rules have the potential to touch virtually every cross-border transaction undertaken by a non-publicly traded U.S. person in a way that so penalizes U.S. persons doing business abroad that it could result in a virtual boycott of cross-border commerce.

¹⁰ See Securities Technology Monitor, August 25, 2011; The Australian Financial Review, August 31, 2011.

The FATCA Proposal provides, for instance, that any non-publicly traded U.S. person that “transferred assets to” an entity that “holds an account, or in any other manner has assets,” in a non-FATCA institution (*i.e.*, an entity not compliant with FATCA’s reporting requirements) is presumed to have control over such entity. Further, any amounts received by the U.S. person from that entity are presumed to be taxable.

Thus, for example, when a non-publicly traded U.S. bank (or other U.S. person) makes a loan to a foreign company, if that foreign company holds assets in a non-FATCA institution (a determination the U.S. bank is unlikely to be able to make), the bank is presumed to control the foreign company. Further, it is presumed that any amount received by the bank from the foreign company -- including, it would appear, a return of principal on the loan -- is taxable income to the bank. This absurd result could only be rebutted by clear and convincing evidence, and the bank could not use foreign-based documents in court to rebut the presumption unless it supplied a witness with knowledge of the document.

The effect is that a U.S. bank (or other U.S. person) making such a loan would need to be aware of every account the foreign company holds (including every investment by the borrower in any investment fund), would need to be able to ensure that the foreign company will not in the future hold any accounts or investments in a non-FATCA institution, and would need to ensure (before entering into the transaction) that it would be able to prove with clear and convincing evidence that it does not control the entity. Such proof would likely be contained in foreign-based documents, meaning that the bank would need to be able to secure a commitment from the foreign borrower that it will provide the bank with a witness who will travel to the United States and testify as to the authenticity of the documents.

Imposing such burdens on cross-border lending, and virtually every other cross-border transaction, is simply not workable, and U.S. business enterprises would have to vastly reduce their cross-border activities. Such a reduction would have a severe chilling effect on U.S. capital markets and the global market place.

V. Taxing Certain Payments on Credit Default Swaps (Levin bill, Sec. 105)

A. Description of the Proposal

A credit default swap (CDS) generally refers to a financial contract under which one party (the protection buyer) purchases from another party (the protection seller) protection against credit default by a particular obligor with respect to a notional amount of a particular debt obligation (the reference obligation).¹¹ Typically, the protection buyer pays either a single lump sum or periodic fees to the protection seller until a credit event occurs or until maturity of the CDS. In exchange, the protection seller is contractually obligated to make a swap payment to the protection buyer if there is a credit event on the reference obligation or reference entity (a credit event payment). Typical credit events include a failure to pay principal or interest on the reference obligation, or the bankruptcy or insolvency of the obligor. Economically, a protection seller is “long” the credit risk of the obligor. At the same time, the protection buyer

¹¹ CDS also may be entered into with respect to a published index the components of which are debt instruments of several unrelated obligors.

has received protection against credit losses with regard to the obligor. Under the terms of the CDS, the protection buyer is not required to own the underlying debt obligation or to incur any actual loss to be entitled to a credit event payment from the protection seller. A CDS may be purchased or sold with respect to a portion or a multiple of the credit risk. The same type of transfer of the credit risk from protection buyer to protection seller can also be achieved through a variety of other financial derivatives that are not a CDS (e.g., total return swaps, options, financial guarantees, and financial guarantee insurance).

Section 105 of the Levin bill (the "CDS Proposal") would determine the source of any payment on a CDS contract by reference to the location of the payor. Consequently, payments (1) from a U.S. protection buyer to a foreign protection seller, or (2) from a U.S. protection seller to a foreign protection buyer, would be subject to U.S. withholding tax. As a result, U.S. market participants in a CDS may be unfairly disadvantaged in the global credit derivatives market. In introducing the CDS Proposal, Senator Levin characterized the current tax treatment of a CDS as a tax "loophole" and CDS transactions as a form of undesirable financial betting. The stated purpose of the CDS Proposal is to eliminate the tax incentive for entering into a CDS and, therefore, stop purported tax avoidance by offshore entities that enter into a CDS.

B. Principal Reasons Why the Proposal Should Be Rejected

1. Current Treatment of CDS Is Not a Loophole

First, current treatment of CDS payments is reflective of the broader policy judgments made about U.S. taxation of payments on financial derivative transactions and is not abusive. Although U.S. tax treatment of many similar financial transactions is not uniform, a CDS represents only one of many types of financial transactions that allow market participants to manage credit risk.¹² Financial transactions, such as options, some total return swaps and outright purchase or sale of the reference obligations, could produce payments that are economically similar to those under a CDS and that would not be subject to U.S. tax.¹³ The prevailing treatment of a CDS is not abusive because a CDS is a type of notional principal contract (NPC).¹⁴ Taxation of NPCs is clear and payments on NPCs (other than dividend equivalent payments sourced in the United States) generally are not subject to U.S. tax. Entering into a CDS is not tax-driven, and by choosing a CDS rather than any other type of financial derivative transactions that are not subject to U.S. tax, parties do not enhance their U.S. tax treatment or avoid U.S. tax that would otherwise be imposed. The CDS Proposal would only exacerbate any existing inconsistencies and potential for achieving different U.S. tax treatment of economically similar financial transactions. Additionally, sourcing CDS protection payments and credit event payments solely by reference to the payor would result in

¹² In Notice 2004-52, the IRS acknowledged that there are many financial derivative transactions that are similar to CDS, including a contingent put option, a contingent notional principal contract, a guarantee, and insurance.

¹³ Consider, for example, if the foreign protection buyer had purchased a put option on the reference obligation instead of entering into a CDS, the payment it would receive from the U.S. protection seller upon the exercise of the put option would not be subject to U.S. withholding tax. If a foreign protection seller entered into a total return swap (which, in addition to transferring credit risk, also would transfer the market risk and interest rate risk on the reference obligation), swap payments made to it by a U.S. protection buyer would not be subject to U.S. withholding tax. Finally, if a foreign person actually held the reference obligation any interest payments generally would not be subject to U.S. withholding tax.

¹⁴ On September 15, 2011, the IRS issued proposed regulations treating CDS as NPCs.

economically identical CDS transactions being taxed differently just because of the U.S. payor. While it may be desirable to revisit how financial derivative transactions are treated under U.S. tax law, such reconsideration should not be piecemeal but should strive for achieving consistency in the tax treatment of similar transactions.

2. CDS Are Not a Form of Undesirable Financial Betting But an Important Risk Management Tool

Second, like other financial derivatives, CDS are not a form of undesirable financial betting. As characterized by the staff of the Joint Committee on Taxation, derivatives “are critically important tools in the risk management process.”¹⁵ The use of a CDS is not limited to the financial industry. Market participants from many industries optimize their credit exposure by purchasing or selling a CDS. Commercial banks may buy protection in order to manage credit risk associated with a particular loan and may sell protection in order to acquire synthetic exposure to other loans. Insurance companies may buy and sell protection both in the conduct of their investment activities and in the conduct of their insurance activities. Pension funds may enter into a CDS to protect their investments in corporate bonds. Manufacturing or service companies may enter into a CDS to protect against a credit default of major customers. A CDS is an efficient means of managing credit risk because a CDS does not require the transfer of the reference debt obligation when credit protection is bought or sold. Although it is believed that the unregulated use of a CDS magnified the extent of the recent financial crisis, the undesirable risks associated with a CDS should be addressed by improving the regulatory process rather than by attempting to curtail any use of a CDS through punitive taxation.

3. The CDS Proposal Would Be Inconsistent With the Dodd-Frank Regulatory Framework

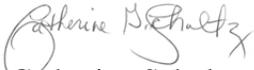
Lastly, the Dodd-Frank Act has established a comprehensive regulatory framework for treating financial derivative contracts. Under that regulatory framework, a CDS is treated and regulated as a swap. The CDS Proposal would be inconsistent with that regulatory treatment by setting a punitive U.S. tax regime specifically for a CDS although there is no principled reason to distinguish them from other swaps. We see no compelling tax policy reason to treat a CDS significantly differently than other swaps that are being subjected to the same regulatory treatment.

VI. Conclusion

U.S. international tax rules can protect the U.S. tax base without undermining the international competitiveness of U.S. businesses. The active operations of U.S. businesses abroad preserve and expand the businesses' operations and employment in the United States. Proposed legislation that is intended to address improper offshore tax avoidance, but that instead unduly reduces the global competitiveness of legitimate U.S. businesses, raises significant policy and practical concerns. The NFTC would be pleased to work with Congress and the Treasury Department to help ensure government efforts to target abusive offshore tax avoidance do not unduly restrict legitimate business operations of globally integrated U.S. businesses.

¹⁵ Joint Committee on Taxation, Present Law and Analysis Relating to the Tax Treatment of Derivatives (JCX-21-08), March 4, 2008, page 4.

Thank you for the opportunity to submit these written comments. The NFTC looks forward to working with you, your staffs, and all Members of the Committee to ensure that U.S. tax reform enhances the competitiveness of the U.S. economy and of U.S. multinational corporations.



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