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Before the House Committee on Ways and Means

Tax Reform Hearing on the Benefits of Permanent Tax Policy for America's Job Creators

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Chairman Camp, Ranking Member Levin, and Members of the Committee, it is an honor to appear before you today to discuss the very important topic of two expired tax provisions, the active financing exceptions to subpart F and section 954(c)(6) of the Internal Revenue Code, also known as CFC look-through.[1] I applaud the Committee for making significant progress on tax reform, and I urge the Committee to make these two provisions permanent as part of tax reform or outside of tax reform.

I also appreciate that this committee is willing to receive testimony from a former Senate Finance Committee staffer.

I am a partner in the Washington office of Baker & McKenzie, a global law firm. However, I appear today on my own behalf, and my testimony does not necessarily reflect the views of my firm or our clients.

Background on Subpart F

Generally, the active income of a U.S.-owned controlled foreign corporation ("CFC") is not subject to U.S. income tax until distributed to U.S. shareholders.[2] In 1962, as a compromise with President Kennedy, Congress enacted a series of exceptions to the general rule, which are collectively known as Subpart F. Under Subpart F, certain categories of income are treated as passive income and are subject to current U.S. income tax. One category of Subpart F income is foreign personal holding company income, which includes in part: (1) dividends, interest royalties, rents, and annuities; (2) net gains from the sale or exchange of property that gives rise to such income; (3) income that is equivalent to interest; (4) income from notional principal contracts; and (5) payments that are equivalent to dividends.

There are exceptions to these rules in the case of same-country payments, such as a dividend from one CFC to another where both CFCs are organized in the same country.

[1] All references to sections are to the Internal Revenue Code of 1986, as amended.
[2] A CFC is a foreign corporation that is more than 50 percent owned by 10 percent or greater U.S. shareholders.

Also, certain insurance income earned by a CFC is treated as subpart F income. Subpart F income includes risks that are insured or reinsured by the CFC in connection with risks located in a country other than the CFC's country of organization. For example, under the general rule, if a CFC organized in Germany ensures property and casualty risk in another European Union country, then such income is taxed currently by the U.S.[3]

Active Financing Exceptions

When Congress enacted Subpart F in 1962, foreign personal holding company income did not include income earned from the active conduct of a banking, financing, or other similar business. This exception from Subpart F was repealed as part of the Tax Reform Act of 1986. Congress restored a version of the exception in the Taxpayer Relief Act of 1997, and significantly tightened the exception in the Tax and Trade Relief Act of 1998.

The active financing exceptions to Subpart F ("AFE") exempt certain income from treatment as foreign personal holding company income or insurance income if a CFC satisfies two tests: an entity-level test and a qualifying income test.

Under the entity test, a CFC must demonstrate that it is predominantly engaged in the active conduct of a banking, financing, or similar business. Generally, a CFC must derive 70 percent or more if its gross income directly from transactions with unrelated customers in the active and regular conduct of a lending or finance business.[4] Moreover, a CFC must also conduct substantial activity with respect to the business. The legislative history contains an extensive list of the activities that a CFC must substantially conduct for the generation of income with respect to the business.[5] Most of the activities must be conducted by the CFC's own employees.

If a CFC can satisfy the entity test, then only those items of income that are qualified banking or financing income are not treated as foreign personal holding company income. The income test is also strict, as it requires that: (1) the income must be derived in the active conduct of a banking, financing, or similar business; (2) the income must be derived from one or more transactions with customers located in a

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[3] For a more complete discussion of these provisions, see *Description of Expiring Business-Related Tax Provisions Made Permanent or Extended Under the "Tax Reform Act of 2014," a Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code*, Joint Committee on Taxation, JCX-35-14 (2014); Lowell D. Yoder, *The Subpart F Exception for Active Financing Income*, 31 TM International Journal 283 (2002); Robert H. Dilworth, *Tax Reform: International Tax Issues and Some Proposals,* International Journal of Taxation (Jan-Feb 2009).

[4] Certain entities regulated by U.S. authorities are deemed to satisfy the test. *See* § 954(h)(2)(A)(i) and (B).

[5] The activities include, but are not limited to: initial solicitation of customers; advising customers on financial needs, including funding and financial products; designing or tailoring financial products to customers' needs; negotiating terms with customers; and making loans, entering into leases, and extending credit with customers that generate income that would be considered derived in the active conduct of a banking, financing, or similar business. *See* H.R. Report 105-825, October 18-19, 1998.

non-U.S. country, substantially all of the activities in connection with which are conducted directly by the corporation or a branch or qualified business unit of the CFC in its home country; and (3) the income must be treated as earned by the CFC or qualified business unit in its home country for purposes of such country's tax laws; and (4) for certain entities, more than 30 percent of the CFC's or qualified business unit's gross income must be derived directly from unrelated customers that are located within the CFC's or qualified business unit's home country.

There are separate entity and income tests for insurance companies under Internal Revenue Code section 953.

These rules are designed to reflect sound tax policies. First, banks, financing and other similar businesses earn income that looks like passive income, but is derived from an active business. AFE appropriately treats such income as active income, and ensures that such financial service businesses are treated the same as other businesses, such as manufacturers and service providers, for purposes of Subpart F. The entity and income rules ensure that only banking, financing, insurance, or similar businesses receive such treatment.

Financial service companies compete across the globe. New York is only one of several financial centers, and U.S.-headquartered businesses compete in foreign centers (e.g., London and Hong Kong) for clients. Foreign-headquartered financial-service companies are generally not taxed currently on their foreign income, and AFE accords U.S.-based multinational corporations ("USMNCs") the same treatment for their foreign operations. Such competition also creates U.S.-headquarter jobs that support the foreign operations.

Many U.S.-based manufacturers establish financing subsidiaries that provide financing for goods sold from the United States. AFE allows U.S.-based manufacturers to offer competitive financing on U.S. exports. Congress should continue to support U.S. manufacturing and ancillary services through the AFE.

Section 954(c)(6) (CFC Look-Through)

Section 954(c)(6) provides an exception to Subpart F for certain payments from one CFC to another that would otherwise be treated as foreign personal holding company income. The provision generally provides that dividends, interest, rents, and royalties received or accrued by one CFC from a related CFC are not treated as Subpart F income, so long as the payments are made out of active foreign income. However, if a CFC receiving such income subsequently invests the payment in a passive investment (e.g., bonds), then Subpart F continues to apply to currently tax the passive income from such investment.

The House and Senate first passed CFC look-through on a permanent basis with substantial bipartisan votes in 2004 as part of the American Jobs Creation Act.[6] Although the provision was not included in the conference report, the next Congress enacted CFC look-through as part of the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"). Congress did not make the provision permanent at that time because it was part of a reconciliation bill. The legislative history states that Congress enacted this provision to remove impediments to business decision-making and allow USMNCs to deploy capital as and where needed without imposing U.S. tax. Congress recognized that businesses are truly global and will need to deploy active foreign income to expand foreign operations and compete with foreign-based multinational corporations.[7] For example, many USMNCs maintain in-house treasury centers for more efficient group borrowing, lending, and hedging activities. The absence of CFC look-through imposes unnecessary restrictions on such activities, which are commonplace among multinational groups.

Congress also recognized that Subpart F is antiquated because it views businesses on a country-by-country basis. However, the world has evolved since 1962, and USMNCs operate on a global basis and in economic zones that are effectively treated as one country by foreign-based MNCs. Until Subpart F is refined to take into account global and multi-country business realities, CFC look-through is an important equalizer for USMNCs.

CFC look-through is important because it helps USMNCs to operate on a global basis. The provision removes impediments that would make it difficult for research centers across the globe to share intellectual property. Moreover, USMNCs can fund operations in locations with the greatest potential for growth, as opposed to resorting to loans from third parties.

Most importantly, CFC look-through allows a U.S. business to align the tax treatment of the global enterprise with the business. Many businesses conduct their affairs by business segment or line of business, and CFC look-through helps eliminate separate entity limitations, thereby allowing a business to truly operate globally by segment or line of business.

Congress Should Make These Provisions Permanent

Permanence is fundamentally important for all Internal Revenue Code provisions because virtually every corporate decision is taken after a careful review of the after-tax return on investment. If the after-tax return on investment is uncertain, business decisions are either delayed or not taken. An Internal Revenue Code run by temporary tax provisions impedes legitimate business decisions, and forces behavior that does not make good business sense.

[6] H.R. 4250 and S. 1637 (108th Cong.).
[7] *See* H.R. Rep. 109-304, 45; JCS 1-07, 267.

While some provisions may be temporary by design (as stimulus measures, for example), AFE and CFC look-through are designed to be permanent tax policy. This has been demonstrated with bipartisan legislation that has been introduced in several Congresses in both the House and the Senate to make these provisions permanent. Continuing a band-aid approach to these provisions undermines the Congressional justification for them.

Permanence is essential for U.S.-based financial service sector businesses. A permanent AFE would eliminate great uncertainty regarding the future tax liability. It would also allow financial service companies to appropriately price products and services. For example, it is difficult to appropriately price a long-term insurance policy if the insurer is unable to determine whether the premiums will be taxed currently as Subpart F income. Further, such certainty will allow U.S.-based financial service businesses to expand operations and effectively compete with foreign-based financial services.

For example, an expired AFE will impede a U.S.-based bank's ability to expand in new markets and to efficiently compete on pricing for new and existing clients. A loan from a CFC to a foreign customer may have a higher interest rate because the CFC's income on the interest is subject to U.S. tax. That difference in interest rates could result in the borrower obtaining the loan from the foreign-based bank. As a result of such lost opportunities, the U.S. bank will face higher costs and may be unable to expand in as many markets as a foreign-based bank.

Permanence takes on added importance with respect to section 954(c)(6) for two reasons. First, taxpayers facing the expiry of 954(c)(6) have, as a general rule, not simply stood by and watched it expire. Instead, they have incurred significant U.S. and foreign accounting, legal, and systems costs to restructure their operations to try to avoid the need to rely on CFC look-through where they can – e.g., by structuring into the same-country exception for foreign personal holding company income found in section 954(c)(3). These are needless costs that do not advance anyone's business or make any company more competitive in the marketplace.

Second, those companies that cannot use an alternative exception may have to reflect the tax impact in their financial statements or footnotes that accompany their SEC filings. Economists and financial accounting experts appearing before you will likely expand on this point. Nevertheless, from a lawyer's perspective, this forces taxpayers to move cash around their structure in ways that they otherwise would not do. Permanence would eliminate these wasted expenses and would allow taxpayers to effectively deploy cash where needed.

Thank you. I would be happy to answer any questions you may have.