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April 15, 2013

The Honorable Adrian Smith
Chair, Financial Services Working Group
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

The Honorable John Larson
Vice Chair, Financial Services Working Group
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Re: Ways and Means Tax Reform Working Group on Financial Services

Dear Representatives Smith and Larson:

The Clearing House Association L.L.C. ("The Clearing House"), an association of major commercial banks,[1] appreciates the opportunity to provide comments to the House Ways and Means Committee's (the "Committee") financial services working group on tax reform. We applaud the work of the Committee and the working group, which we hope will lead to reforms that will grow the economy, create jobs, and simplify the system.

Our comments are focused primarily on corporate tax reform, which we believe should be an integral component of a comprehensive tax reform bill. We approach proposals from multiple perspectives, including the impacts on bank customers, banks as businesses and taxpayers, and the financial markets overall. Given the important responsibilities of the banking industry in tax withholding and information reporting, we also consider relevant proposals (e.g., the financial products "discussion draft" released by Chairman Camp)[2] from the perspective of administrability by banks that would have to implement them.

The following are among the key tax reform issues for The Clearing House:

- Corporate tax rate reduction: We support a significant reduction in the corporate tax rate (e.g., the 25% rate proposed by Chairman Camp) as part of a comprehensive reform bill, and are encouraged that a bipartisan consensus is emerging on this point. The 35% U.S. corporate tax

[1] Established in 1853, The Clearing House is the nation's oldest banking association and payments company. It is owned by the world's largest commercial banks, which collectively employ 1.4 million people in the United States and hold more than half of all U.S. deposits. The Clearing House Association is a nonpartisan advocacy organization representing -- through regulatory comment letters, amicus briefs and white papers -- the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer and check-image payments made in the U.S. See The Clearing House's web page at www.theclearinghouse.org.

[2] "Camp Releases Financial Products Tax Reform Discussion Draft," House Ways and Means Committee, January 24, 2013 (http://waysandmeans.house.gov/news/documentsingle.aspx?DocumentID=317688).

rate is sharply higher than rates imposed by other industrialized countries and serves as a barrier to investment and economic growth. A corporate rate reduction will make the U.S. tax regime fairer and help bank customers grow their businesses and provide more jobs.

A corporate rate reduction would result in a write-down in the value of most deferred tax assets ("DTAs"), producing a charge to earnings for companies that have net DTAs. This charge, driven by the reduction in DTAs (which represent future tax deductions and attributes "priced" at the enacted future tax rate), can be quite substantial for some. The banking industry will experience this impact to a greater degree, as many banks have DTAs associated with deferred deductions such as loan losses already expensed. Nevertheless, we believe the long-term benefits to the U.S. economy of a corporate rate reduction outweigh the costs of these one-time write-downs.

- Interest deductibility: It has been suggested that there be limitations on the deductibility of interest expense to address a perceived bias for debt financing under current law. In considering possible limitations, policymakers should weigh the potential impacts on the ability of businesses to expand and make new capital investments. We would note that any preference for debt financing that exists today will be addressed at least in part by a corporate tax rate cut, which will reduce the relative value of interest deductions. Some would recommend that perhaps a better tax policy approach would be to eliminate the double tax on equity.

  As a general principle, Federal tax reform should maintain the general deductibility of interest as an ordinary and necessary business expense. Deductibility of interest is not a "tax expenditure."[3] We would urge the Committee to reject proposals that would deny interest deductions on an across-the-board basis. For example, Sen. Ron Wyden (D-OR) and Sen. Dan Coats (R-IN) have introduced legislation[4] that would deny a deduction for a flat percentage of gross interest expense (i.e., the portion deemed to be attributable to inflation), even if the taxpayer has a relatively low level of debt. If changes are considered, they should be targeted at specific tax policy concerns. For example, Chairman Camp's international tax discussion draft,[5] released in 2011, includes a "thin capitalization" rule targeting disproportionate borrowing in the United States. The proposal would disallow deductions for U.S. multinationals for net interest expense that exceeds a percentage of income, but only if the U.S. group is overleveraged compared to the worldwide group.

  Policymakers also must consider the unique business model of banks in connection with any limitations on interest expense deductibility. In general, banks borrow in order to obtain funds to lend, and their income is the difference between the interest banks pay on borrowings and the interest banks earn on loans. If interest expense were not deductible by financial intermediaries as an input, the profit margin for a lending business would be severely impacted

[3] See, e.g., Joint Committee on Taxation, *Estimate of Federal Tax Expenditures for Fiscal Years 2012-2017,* (JCS-1-13).
[4] S. 727, 112th Cong.
[5] "Camp Releases International Tax Reform Discussion Draft," House Ways and Means Committee, October 26, 2011 (http://waysandmeans.house.gov/news/documentsingle.aspx?DocumentID=266168).

and perhaps eliminated – the effective tax rate could exceed 100%. As a practical matter, however, if deductions were disallowed, this cost likely would be passed on to borrowers in the form of higher lending rates. These adverse consequences can be avoided by focusing any potential limitation on net interest expense (i.e., interest expense in excess of interest income), as other countries that have imposed limitations on interest expense deductibility generally have done. Finally, we believe that tax legislation should not be used to achieve other regulatory policy objectives.

- International tax reform: We support efforts to move toward a competitive territorial-type system that generally exempts active foreign-source income, consistent with systems adopted by most other countries, and we recognize that rules will be needed in connection with such a system to address potential "base erosion."

  An important threshold question in designing a territorial-type system is how to address U.S. expenses that may be associated with generating foreign-source income. The international tax "discussion draft" released by Chairman Camp in 2011 takes what we think is the right approach by haircutting the exemption by 5% (i.e., providing a 95% exemption) as a proxy for allocating such expenses to exempt income. A requirement to allocate interest expense, for example, would raise significant concerns, including the fact that allocation mechanisms are complex, imprecise, and create distortions, particularly for banks. We also would note that no major OECD country allocates interest expense in connection with territorial taxation.

  A critical issue for financial services companies in a territorial-type system is ensuring that active business income earned by bank foreign subsidiaries is eligible for exemption, just like active income earned abroad by other service providers and manufacturers. Under current law, the active financing exception ("AFE") rules under Code section 954(h)[6] provide that income earned from lending-related activities in foreign markets is eligible for the same deferral treatment applicable to other industries. The AFE rules generally distinguish the active interest income earned in the conduct of banking from passive interest income, which is subject to immediate U.S. tax (under Subpart F). If passive income earned abroad continues to be subject to U.S. tax in a territorial-type system, it will be necessary to maintain an AFE-type exception. We would urge that such rules be permanent, in contrast to the current law AFE rules, which were enacted in 1997 on a temporary basis and have been extended seven times since.

  Finally, tax reform legislation should maintain the principle that foreign income should not be subject to double taxation. While there will be less reliance on foreign tax credits in a territorial-type system, a foreign tax credit system will still be needed to prevent double taxation of passive income and income that is not eligible for exemption pursuant to a base-erosion rule. Current law foreign tax credit rules, particularly foreign tax credit carryover and the overall domestic loss rules that prevent double taxation, should be maintained in a reformed system.

[6] Section 954(h) of the Internal Revenue Code of 1986, as amended (the "Code").

- Financial products "discussion draft": We commend Chairman Camp for considering ways to simplify and rationalize the tax treatment of financial instruments. The derivatives "mark-to-market" proposal in the financial products discussion draft requires particular consideration. Complex issues are raised, and the broad definition of a "derivative" will need to be refined to avoid unintended consequences and impediments to essential marketplace functions (e.g., securities lending/repo markets). We applaud the proposed exception for business hedging which is important to many business customers, and would urge the Committee to consider what principles should govern further exceptions (e.g., for common retail transactions, for instruments in the nature of investments, etc.) from mark-to-market treatment.

  Valuation rules for mark-to-market taxation will require careful development. These should leverage readily available "marks" (e.g., from derivatives clearing organizations) and reflect the fact that taxpayers and firms may have differing valuation methodologies.

- Neutrality: A final point is that tax reform legislation should produce a system that is more neutral with respect to investment decisions and that avoids picking "winners and losers." We would expect that differences in corporate effective tax rates among companies and industries would be narrowed as a result of Federal tax reform. Likewise, we would urge lawmakers not to impose new sector-specific taxes that penalize particular industries.

Thank you for considering our views. If you have any questions or are in need of any further information, please contact me at (212) 613-9883 (email: david.wagner@theclearinghouse.org).

Sincerely yours,

David Wagner
Executive Managing Director
and Head of Finance Affairs

cc:

The Honorable Dave Camp
Chairman, Committee on Ways and Means
U.S. House of Representatives

The Honorable Sandy Levin
Ranking Member, Committee on Ways and Means
U.S. House of Representatives

Mr. Bill McNairy
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Chair, TCH Tax Committee