Letters To The Editor

## McIntyre Returns Fire on Financial Services Industry Provision

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*The following is the full text of a letter to the editor from Professor Michael McIntyre in response to criticism from the Securities Industry Association over his earlier letter on the proposal to eliminate certain financial services income from the subpart F regime.*

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To the Editor:

In a recent commentary piece published in this journal, I argued against the creation of a special exemption from the antiavoidance rules of subpart F for the dividend, interest, and other personal holding company income earned by the financial services industry. (See Tax Notes Int'l, Sept. 15, 1997, p. 837, or Doc 97-25843 (4 pages).) That piece was written in response to a letter to the editor from Edward Kleinbard, a lobbyist for the securities industry, who had attempted to create the utterly false impression that his client firms were operating only in high-tax countries and were not avoiding tax on the subpart F income that they derived in those countries. (See *Tax Notes Int'l*, Sept. 1, 1997, p. 695, or Doc 97-24270 (3 pages).) Writing on behalf of the Securities Industry Association, Marc Lackritz has taken exception to several of my points. (See *Tax Notes Int'l*, Oct. 6, 1997, p. 1093, or Doc 97-27677 (3 pages).) I reply to those points here.

A central area of disagreement between me and Messrs. Lackritz and Kleinbard is over the amount of taxes that U.S.-based financial services firms are paying abroad on the income that they want exempted from subpart F. My core point is that the type of income reached by subpart F is difficult for the source country to tax and usually is not taxed, even in ostensibly high-tax countries like the United Kingdom, absent the tax umbrella provided by subpart F itself. I acknowledged in my prior piece that the securities industry, like the insurance industry, requires a substantial presence in the countries in which it earns income and that the returns from its onshore activities are taxed. I predicted, however, that unless the onshore and offshore activities of the securities firms are provided a level playing field, "the financial services industry will go the way of the insurance industry, with some unmovable residual part of the business remaining at home and the highly profitable part moving offshore."

In my piece, I did not offer any specific information about the taxes being paid to foreign governments by various securities firms on their overseas activities. The important information about the effective foreign income tax rates on subpart F income in particular countries does not appear in the public domain. What I did say in that piece and repeat here is that the [*1280] securities industry would not be lobbying so forcefully for subpart F relief on its dividend, interest, and other personal holding company income unless it was avoiding a significant amount of foreign tax on that income.

In support of his contrary view, Mr. Lackritz provides data from the annual reports of Merrill Lynch, Morgan Stanley, and Salomon Inc. showing that for the period 1994-96, those firms made provision on their financial statements for significant non-U.S. income taxes. I looked at the annual reports of those three firms; I also reviewed the annual reports for Bear Stearns, CitiBank, and Bankers Trust, all of which are potential beneficiaries of the amendment to subpart F that Mr. Lackritz is promoting.

Some of the information in these reports is helpful and on point. It was useful to learn, for example, that Merrill Lynch and its affiliates have "major offices" in Grand Cayman, Panama, Hong Kong, Isle of Man, Luxembourg, Monaco, and Switzerland. All of these locations appear on the list of tax haven countries prepared by tax practitioners who specialize in international tax avoidance.[1] It was also useful to see that the securities industry is in vibrant good health, is earning enormous profits, and is expanding aggressively overseas.

Although those annual reports provide some useful information, they do not show anything meaningful for the debate over subpart F about the foreign taxes paid by the securities industry. They show nothing about the taxes imposed in particular countries, about the relationship of taxes paid to income earned in particular countries, or about the foreign income taxes paid with respect to the highly mobile subpart F income that was the focus of my commentary piece.

Mr. Lackritz and the Securities Industry Association for which he speaks have made the amount of income taxes that the international securities firms pay to foreign governments central to their case for special tax relief. If that is the basis for their case, then they should be obligated to make public disclosure of the relevant tax information about their overseas operations. When an out-of-work mother with young children requests governmental assistance to help her through hard times, she is required to disclose all relevant details about her assets and her income. Yet when some of the richest companies in America, enjoying the very best of times, come to Congress asking for huge tax subsidies, they apparently are not being required to reveal to the public any of the relevant particulars about their financial affairs.

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[1] I was recently criticized in a letter to the editor written by Jefferson Vanderwolk for referring to Hong Kong as a tax haven. (See *Tax Notes Int'l*, Sept. 29, 1997, p. 1013, or Doc 97-27145 (2 pages).) His quarrel is with the writers of the tax haven books, however, and not with me. I believe that Hong Kong is usually listed as a tax haven by tax practitioners because its onshore tax rate is about 20 percentage points below the international norm for the major industrial countries and it generally does not tax offshore income.

The tax break at issue is worth many, many millions of dollars to the securities industry and many millions more to offshore banks and offshore insurance companies. The American taxpayer will be asked to pick up the bill. Is it really too much to ask under these circumstances that the firms asking for these huge tax subsidies be required to put their financial cards on the table? I think not.

In addition to our general area of disagreement discussed above, Mr. Lackritz raises some specific points about my prior piece that deserve some comment. I will address those points as best I can, given the limited information [*1281] that is publicly available on the actual tax practices of the firms he represents.

First, Mr. Lackritz is correct that all of the firms in his three-firm sample reported "foreign taxes" for most years, sometimes in substantial amounts, on their financial books. The same is true of the three additional firms that I surveyed. This information can be seen as appropriate rebuttal to the remark I made in my commentary piece that "the financial services industry is almost never taxed by the source country." My statement, however, must be understood in the context in which it was made. I was replying to the false claim of Mr. Kleinbard that his client firms were operating only in high-tax countries and were not avoiding tax on the subpart F income that they derived in those countries. As discussed above, my intended meaning, which other parts of my commentary piece hopefully made clear, was that the type of income reached by subpart F is difficult for the source country to tax and usually is not taxed absent the tax umbrella provided by subpart F itself.

The accounting data referred to by Mr. Lackritz are not helpful in understanding what taxes the securities firms are actually paying to foreign governments on the income that Mr. Lackritz wants exempted from subpart F. No country-specific data is given at all. The annual reports do not even tell us much that is useful about overall foreign tax burdens. I could not learn from those reports, for example, whether the firms in the six-firm sample were paying income taxes to foreign governments at a low or a high effective tax rate or whether their subpart F income was being taxed by particular foreign governments at significant rates.

To illustrate why the information in these annual reports is not revealing, I will discuss briefly the information about Merrill Lynch's foreign taxes contained in Mr. Lackritz's letter. As Mr. Lackritz correctly reported, Merrill Lynch showed negative foreign taxes for 1995; for 1994, it showed a relatively small amount of foreign taxes, considering the size of its foreign operations. For 1996, however, it showed foreign taxes of $460 million, which is a large number even considering that the firm reported net revenues in that year of $5.8 billion, $3.3 billion of which its accountants allocated to foreign operations.

For none of the years at issue does Merrill Lynch disclose how much of the amount labeled "foreign income taxes" represents taxes relating to the offshore activities of Merrill Lynch itself rather than to the activities of its foreign affiliates. Merrill Lynch's own activities are unaffected by the subpart F rules. In addition, Merrill Lynch made some very large foreign acquisitions during the relevant period, yet there is no information on how much, if any, of the amounts shown as foreign taxes relate to the activities of the acquired companies.

Merrill Lynch's annual report did include some aggregated figures for the "earnings before income taxes" attributable to its foreign affiliates for 1994-96. I divided the "income taxes paid" figure by that "earnings before taxes" figure for each year and got, respectively, 10 percent, negative 30 percent, and 62 percent. These numbers do not make sense. I am not sure what to make of the 10 percent number or the negative 30 percent number. The 62 percent number, however, suggests that the "income taxes paid" figure may include taxes other than the taxes paid by the foreign affiliates.[2] Obviously none of the foreign countries in which Merrill Lynch operates has an effective tax rate anywhere close to 62 percent. [*1282]

Similar problems arose from the data contained in other annual reports. For example, Bear Stearns reported "foreign income taxes" of $14 million and "foreign earnings before taxes" of $3 million for 1995. When I divided $14 million by $3 million, I got 467 percent as the effective tax rate. The math is right, but something else must be wrong or the tax department at Bear Stearns would be looking for work.

Not all of the firms in the six-firm sample give the same information about their foreign operations. Merrill Lynch revealed more than some on some points and less than others on other points. The common thread was that none of the reports provided information that was useful in deciding how the securities industry is being taxed on income currently taxable under subpart F— the issue raised by Mr. Kleinbard that got me started on this topic. Nor did the reports give a breakdown of foreign taxes or foreign income by country.

The firms themselves feel obliged to warn investors that the limited accounting information they have published about their foreign operations is not particularly revealing. The following is quoted from the annual report of Morgan Stanley:

> *Because of the international nature of the financial markets and the resulting geographical integration of the Company's business, the Company manages its business with a view to the profitability of the enterprise as a whole, and, as such, profitability by geographic area is not necessarily meaningful.*

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[2]There may also be other problems, including timing problems and income measurement problems.

In summary, the annual reports I surveyed support Mr. Lackritz's claim that the major American securities firms in our sample have made provision on their financial statements for significant non-U.S. income taxes in many of the years surveyed. Those reports do not provide even a scintilla of support for Edward Kleinbard's claim that the securities firms operate only in high-tax countries and are not avoiding tax on the subpart F income derived in those countries.

Second, Mr. Lackritz accuses me of arguing that subpart F "includes only foreign-source income that has not been subject to foreign tax." I made no such statement. As anyone familiar with subpart F understands, it applies to various categories of income that are commonly thought to be undertaxed in the source country, with an exception for items of income taxed by a foreign government at an effective rate of at least 90 percent of the top U.S. corporate rate.[3] I noted explicitly in the prior piece that the United States would give a foreign tax credit for any foreign income taxes imposed on the subpart F income.

The point I made is that subpart F, in combination with the foreign tax credit rules, imposes a tax burden on American securities firms only to the extent that they have avoided tax in the source country on their subpart F income. Firms paying high foreign income taxes on that income are effectively immune from taxation under subpart F. As noted above, the securities industry would not be pressing for subpart F relief on its dividend, interest, and other foreign personal holding company income unless it was avoiding a significant amount of foreign tax on that income.

Let me add an additional clarifying point. Controlled foreign corporation (CFC) legislation has been adopted by 17 other countries since the United [*1283] States blazed the trail over 35 years ago. That legislation tends to provide a tax umbrella that protects the taxing authorities in the source countries from the strong competitive pressures undermining source taxation of movable income. This umbrella is far from perfect, but it probably does result in some of the movable income earned by foreign and domestic securities firms being taxable in the source country. Despite the imperfections of the system, it is the best we have, and the best short-term hope for mitigating international tax avoidance. To rend it, to tear it asunder, as the financial services industries are asking, would be a major setback for international cooperation on tax matters.

Third, Mr. Lackritz accuses me of predicting that "the bulk of the U.S. financial services businesses will be moved offshore" if those businesses are not subject to current taxation. Mr. Lackritz suggests, and I concur, that it is "completely unrealistic to suppose...that U.S. securities dealers will move their employees and operations out of the United States and into tax havens merely to avoid taxes." Of course I never said anything about moving employees to tax havens.

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[3]For a full discussion of the intricacies of subpart F, see Michael J. McIntyre, *The International Income Tax Rules of the United States*, Michie Co. (1989 with annual updates).

What I actually said and have alluded to above was that "a large part" of the U.S. insurance industry moved offshore because of a failure of Congress to impose current taxes on its offshore earnings and that "the question now is whether the United States will lose its domestic financial services industry—particularly the securities industry— for pretty much the same reasons."

The insurance companies did not "move their employees and operations out of the United States and into tax havens." The part of their business that was movable, and that should have been taxed under subpart F, was moved to low-tax jurisdictions, only some of which are classic tax havens.[4] Primarily the movable part was the reinsurance business. Most of the sales and analysis parts stayed onshore. Or at least that is my understanding of what happened, drawn primarily from second-hand reports that I believe are reliable. I think the analogy to insurance, although not compelling, is seriously troubling. Mr. Lackritz does not take issue with that analogy. He chooses instead to attack his own hyperbolic version of my prediction.

Fourth, I am criticized by Mr. Lackritz for stating that what the securities industry is clearly after in lobbying for repeal of the relevant provisions of subpart F "is exemption from all income taxes." According to Mr. Lackritz, "[i]ncome that is exempted from the rules of subpart F does not escape U.S. tax, however. Rather, it is subject to U.S. tax in the hands of U.S. shareholders under the generally applicable realization rules, i.e. when they receive it...."

There is a sense in which Mr. Lackritz and I are both right. I am correct that the special tax break that Mr. Lackritz is lobbying for would result in a current exemption, and Mr. Lackritz is correct that a possibility remains that some tax would be imposed in some future year if the sheltered income gets distributed. I think we would both agree, moreover, that deferral of tax is a major benefit - - otherwise the securities firms would not be lobbying to obtain it. We should also be able to agree that deferral is equivalent to a full or partial exemption, depending on the length of the deferral. Simple arithmetic shows that a tax deferral for an indefinitely long time is the practical equivalent of a full exemption. [*1284]

In going through the various annual reports that Mr. Lackritz prodded me to read, I found good evidence as to how long these firms expect to enjoy deferral. The following quotation from Note 10 of the annual report of Merrill Lynch is typical:

> *Cumulative undistributed earnings of foreign subsidiaries were approximately $1,206 [million] at December 27, 1996.* ***No deferred Federal income taxes have been provided for the undistributed earnings*** *as these earnings have been reinvested in Merrill*

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[4]Congress has imposed taxation under subpart F on some aspects of the insurance business, but the barn door, once left open, has been very difficult to close.

*Lynch's foreign operations.* (My emphasis.)

The significance of this statement is that Merrill Lynch has told its certified public accountants that it believes that the repatriation of the undistributed earnings of its foreign affiliates is so remote a possibility that it does not need to account for that possibility on its financial books. If repatriation were not remote, Merrill Lynch would be required by its accountants to set up a deferred taxes account for the additional federal income taxes that would become due on repatriation. All of the other firms in our sample have reached a similar conclusion about the likelihood of future taxes being paid any time soon.

One major point I made in my commentary piece that Mr. Lackritz did not comment on is that the proposed exception for the so-called "active" business income of the financial securities industries is inconsistent with the principles underlying subpart F. Contrary to the claim made by Mr. Kleinbard, there is no generally applicable exemption for active business income under subpart F.

On the contrary, many of the types of income taxable under subpart F are derived from an active business under any conceivable definition of that term. Those types would include: income derived from the operation of a shipping business, from operating an airline business, from mining mineral deposits on the ocean floor, from buying and selling goods involving a country other than the country of production or sale, and from engaging in certain oil-related activities, including the refining of crude oil. The common theme is that these business activities, like the activities engaged in by the financial services industries, have created serious problems of tax avoidance over the years.

Mr. Lackritz wants his client companies to be exempt from tax under subpart F on the category of subpart F income called "foreign personal holding company" (FPHC) income. That category includes dividends, interest, gains from sales of stock and various other capital assets, gains from commodity transactions, gains from foreign currency transactions, certain interest-equivalent income, and other types of easily movable income. Congress has added to the list of included items over the years, as it has come to realize their tax- avoidance potential.[5] Many taxpayers earn these items of income by utilizing the services of the securities industry. The tax-avoidance potential of these income items typically is the same whether they are earned by a securities firm on its own account or on the account of a customer. [*1285]

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[5]Indeed, Congress added two new items to the list just this year. See Internal Revenue Code section 954(c)(1)(F) (income from notional principal contracts) and (G) (payments in lieu of dividends). The last item reflects a congressional attempt to keep up with one of the latest tax-avoidance schemes hatched by the securities industry. Some items generally included on the subpart F list are removed for dealers. A securities firm may be a dealer in some cases. Dividends, interest, and a number of other important items on the list are subpart F income whether or not the recipient is a dealer.

In closing I would like to thank Mr. Lackritz for his spirited discussion of some of the issues I addressed in my commentary piece. I also thank him for giving me the occasion to correct any possible misunderstanding about the grounds for my opposition to the entirely unwarranted exemption from subpart F that he is promoting on behalf of the securities industry.

Sincerely,

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