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LEGISLATIVE & REGULATORY

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The Institute's mission is to help resolve the many special legislative, regulatory and tax issues confronting **internationally headquartered** financial institutions that engage in banking, securities and/or insurance activities in the United States.

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INSTITUTE WRITES SEC CHAIRMAN DONALDSON URGING PROMPT ACTION ON INSTITUTE'S PROPOSED EXEMPTION FOR INTERNATIONAL BANKS FROM SECTION 402 OF THE SARBANES-OXLEY ACT

Executive Summary

The Institute on May 28th sent a letter to Securities and Exchange Commission Chairman William Donaldson urging the SEC to act on the Institute's proposed exemption for international banks from the insider lending prohibitions under Section 402 of the Sarbanes-Oxley Act of 2002 (the letter and related documents are available in the member area of the Institute's web site at www.iib.org/member/Sarbanes-Oxley/). We understand that the Institute's proposed exemption, submitted to the SEC on August 16, 2002, is currently being considered by the SEC staff. However, to ensure that this matter is finally resolved over the next month or two, it is critically important that further communications be sent to the SEC from member institutions, national and regional banking associations and particularly from home country governmental authorities.

Section 402 generally prohibits certain issuers from making personal loans to their directors and executive officers. International banks or their parent companies that have securities listed on a U.S. exchange are subject to Section 402, which affects the ability of the head offices of international banks to make loans to their non-U.S. directors and executive officers. In this regard, Section 402 represents an unprecedented extension of the U.S. securities laws into an area that falls squarely within the supervisory jurisdiction of international banks' home country bank supervisors.

In the letter to Chairman Donaldson, the Institute urged the SEC to act promptly to address the acute national treatment issues created by Section 402, which contains an exemption for FDIC-insured U.S. banks but not for international banks. As previously reported, the Commission's senior staff has acknowledged publicly that the lack of a comparable exemption for international banks places them at a disadvantage vis-à-vis U.S. banks and is inconsistent with the spirit of the Act under which U.S. and non-

U.S. issuers are to be treated the same. The Treasury Department has previously communicated its view to the Commission that the Institute's concerns merit prompt attention.

In its submission last August, the Institute urged the SEC to adopt a two-part exemption to Section 402 for international banks, in deference to international bank supervisory standards and to ensure national treatment for international banks. Under the Institute's proposed exemption, international banks from jurisdictions that the Federal Reserve Board has determined provide comprehensive consolidated supervision would be exempt from Section 402. International banks from other jurisdictions would be permitted to make loans without regard to the prohibitions in Section 402 if the loans comply with the core principles of U.S. bank insider lending regulations. The Institute also sent letters to Federal Reserve Chairman Greenspan and then Treasury Secretary O'Neill urging their support for the Institute's proposed exemption.

INSTITUTE CONTINUES TO URGE REMOVAL OF “STATE FLOOR” LIMITATION ON COMPTROLLER’S AUTHORITY IN REGULATORY RELIEF BILL DEALING WITH REFORM OF CED REQUIREMENT

Executive Summary

On May 20th, the House Financial Services Committee approved regulatory relief legislation that includes a provision providing the Comptroller of the Currency discretion in applying capital equivalency deposit (CED) requirements to federal branches and agencies of international banks. The provision, however, also bars the Comptroller from setting the CED in any given state at a level below that state’s comparable asset pledge requirement. While expressing strong support for reform of the statutorily mandated 5% CED requirement, the Institute continues to urge the removal of any “state floor” limitation on the Comptroller’s discretionary authority. The Financial Services Regulatory Relief Act of 2003 (H.R. 1375) is expected to reach the House floor by the latter part of June or July. Similar legislation has not yet been introduced in the Senate.

In letters sent to Chairman Oxley and the other members of the Financial Services Committee, the Institute argued that the “state floor” in section 107 of H.R. 1375 does not really protect the public interest but limits, for reasons that cannot be justified on the basis of safety and soundness considerations, the Comptroller’s supervisory authority to set CED requirements on risk-focused principles. The Institute also pointed out that the “state floor” is inconsistent with the principle of national treatment established by the International Banking Act of 1978 and accorded to international

banks doing business in the United States. The Institute plans to send similar letters to members of the Senate Banking Committee.

As previously reported, the Institute successfully completed its multi-year initiative on asset pledge reform in New York and Connecticut and has continued to pursue the necessary statutory changes to obtain similar relief for member institutions with federally-licensed branches and agencies.

INSTITUTE PLANS TO COMMENT FAVORABLY ON OCC PROPOSAL TO SIMPLIFY APPROVAL PROCESS FOR FEDERAL BRANCHES AND AGENCIES OF INTERNATIONAL BANKS

The Office of the Comptroller of the Currency has issued for public comment a proposed rule that would simplify approval procedures for international banks seeking to establish Federal branches and agencies in the United States (the Federal Register notice of the proposed rule is available on the Institute’s web site at www.iib.org/member/FederalRegister.pdf). The Institute held a meeting on the proposed rule for interested member institutions on May 27th and

plans to comment favorably on the proposal (comments are due by June 23rd).

The proposed rule includes the following revisions: i) eliminates the requirement for an international bank to file an application with the OCC in certain circumstances when it downgrades its U.S. operations; ii) requires approval, but not a new license, for additional Federal branches or agencies opened after the establishment of the initial

branch office; and iii) clarifies that an international bank with Federal branches and agencies in more than one state may consolidate its capital

equivalency deposits (CEDs) in one deposit account in a depository bank that satisfies certain criteria.

INSTITUTE CONTINUES INTENSIVE LOBBYING EFFORTS REGARDING PROPOSED “EARNINGS STRIPPING” LEGISLATION THAT WOULD DISALLOW DEDUCTIONS FOR INTEREST PAID TO AFFILIATES

Executive Summary

The Institute has been continuing its intensive lobbying efforts against proposed tax legislation (the “earnings stripping” interest disallowance rule) being considered by the U.S. Treasury Department and the House of Representatives Ways & Means Committee, which would have a severe adverse impact on U.S. branches and securities affiliates of many international banks.

Earlier this month, the Institute was invited to meet with House Ways & Means Committee Chairman Thomas, who outlined a revised proposal that is highly responsive to the concerns of the Institute and its member banks. Based on Chairman Thomas’ description of his revised “earnings stripping” proposal, the Institute and a number of member banks indicated that they would support his international tax legislation package.

Notwithstanding this favorable development as well as the Senate Finance Committee’s opposition to a general expansion of the “earnings stripping” rule, the political situation is fluid and unstable, and the Institute remains concerned that the final legislative package could very well contain an “earnings stripping” rule that is detrimental to international banks. Accordingly, the Institute is continuing to actively monitor the situation and to lobby Congress and the Administration on this vital issue.

The “earnings stripping” proposal that had been proposed by Chairman Thomas and the Treasury Department last year would have added a new “worldwide limitation” to the existing “earnings stripping” rule, which would compare the leverage ratio of the U.S. operations of a foreign-owned multinational group to the leverage ratio of the worldwide group, and would disallow the *gross* amount of interest paid by the U.S. operations to, or guaranteed by, the parent or its non-U.S. affiliates to the extent attributable to the “excess” leverage of the U.S. operations over the leverage of the worldwide group.

In response to concerns raised by the Institute and others, in February the Treasury Department proposed to add a safe harbor setting forth specific debt-to-asset ratios for different

categories of assets. However, the safe harbor ratios are much lower than prevailing ratios in the financial industry (both in the U.S. and abroad). As a result, major financial institutions are unlikely to be helped by the Treasury’s proposed safe harbor.

At the Institute’s meeting with Chairman Thomas earlier this month, he outlined the following changes that he proposes to make to the “earnings stripping” proposal:

1. There would be no worldwide limitation requiring that the leverage of the U.S. operations conform to that of the worldwide group.
2. The existing law’s “adjusted taxable income limitation” (which, in general, limits the

deduction for interest paid to, or guaranteed by, foreign affiliates if and to the extent the U.S. group's net interest expense exceeds 50% of tax EBITDA) would be revised in the following respects:

- (a) The limitation would be reduced from 50% to 35% next year and to 25% thereafter. However, the 50% limitation would continue to apply to the extent that third-party borrowings are guaranteed by foreign affiliates. Also, the limitation would continue to apply only if and to the extent that the U.S. group has net interest expense.
- (b) The 1.5:1 debt-to-equity safe harbor would be eliminated, and would not be replaced with alternative safe harbor ratios (such as those proposed by Treasury).
- (c) Disallowed interest expense could be carried forward for 10 years.

- (d) There would be no "excess limitation" carryforward.

In proposing these changes, the Chairman and his staff indicated that they accept our fundamental contention that financial institutions operate on a different business model than industrial companies and that neither the worldwide limitation nor Treasury's proposed safe harbors were appropriate for financial firms.

The Institute is very gratified by this most recent development. However, the political situation is extremely fluid. The Institute believes that Treasury Department tax policy officials still favor, at least as a conceptual matter, a worldwide limitation with safe harbor ratios. In addition, opposition to Chairman Thomas' latest international tax proposals exists among politically active U.S. as well as foreign-based multinational industrial corporations. We are continuing to monitor the situation and, to the extent possible, will seek to facilitate a favorable outcome.

INSTITUTE EXPRESSES CONCERN REGARDING PROPOSAL TO REQUIRE CHIEF EXECUTIVE OFFICER TO SIGN TAX RETURNS

Legislation pending in Congress contains a provision that would require the CEO of a corporation to sign the corporation's U.S. federal income tax returns. While taxpayers have generally criticized this provision, it would raise particular complications for U.S. branches of international banks and any "deemed" permanent establishments of their securities affiliates.

Therefore, the Institute submitted a letter to Congress and the Treasury Department recommending that if the provision is enacted notwithstanding the

general concerns that have been expressed regarding its efficacy and the burdens it would impose, at a minimum it should be modified to enable the Treasury Department to issue regulations applying the rule to foreign corporations, including authorizing the senior U.S. executive officer to sign the return.

In addition, the Institute's lobbyist at Washington Counsel Ernst & Young has been discussing the problems presented by this provision with key Congressmen and Congressional staff members.

INSTITUTE SUBMITS COMMENT LETTER TO THE OECD REGARDING ITS REVISED DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS

Executive Summary

As previously reported, in March the OECD released a revised version of Part II of the Discussion Draft on the attribution of profits to permanent establishments (PEs), which focuses on bank branches, and also released a draft of Part III, which discusses global trading of financial instruments by financial institutions. The Discussion Draft could have a major impact on the manner in which a multinational bank is taxed in each country in which it conducts business.

The basic approach of the revised Discussion Draft has not changed materially from the earlier version, which raised practical, business and administrability concerns. Because the Institute's previous submissions to the OECD expressed at some length the Institute's concerns regarding the WH and because the OECD does not seem to be inclined to modify its basic approach, the comment letter that the Institute submitted to the OECD this month focused on several salient points as to which the Institute believes that there is a reasonable prospect of influencing the OECD.

The Discussion Draft proposes as a Working Hypothesis ("WH") a new, comprehensive framework for determining under income tax treaties the amount of profits that should be attributed to the various foreign branches (and head office) of a multinational bank. Significantly, the document proposes to allocate equity capital to each branch (for purposes of determining its deductible interest expense) based on the risk-weighted assets (and off-balance sheet exposures) of the branch, which in turn would be determined based on a functional analysis that focuses on where the "people functions" relating to the creation and management of those assets and risks take place.

While the original version of the Discussion Draft had proposed using, as a proxy for allocating equity capital, the risk-weighted capital standards under the Basel Accord for bank regulatory standards, the revised Discussion Draft acknowledges that it will not be possible to develop a single internationally accepted approach – or even a hierarchy of approaches – for attributing equity capital.

The Discussion Draft could have a major impact on the manner in which a multinational bank is taxed in each country in which it conducts business. Because the Institute's previous submissions to the OECD expressed at some length the Institute's concerns regarding the WH, this comment letter focuses on several salient points, including the following:

1. The Discussion Draft should permit taxpayers greater flexibility in applying the functional analysis in a manner that (i) is consistent with the OECD's Transfer Pricing Guidelines and the arm's length principle and (ii) reduces compliance costs and burdens. Also, under income tax treaties, taxing jurisdictions should be required to accept results that are within an arm's length range as determined by the taxpayer using an acceptable method, regardless of whether that method conforms with domestic tax law.

2. The Discussion Draft should permit appropriate adjustments to address distortions attributable to off-balance sheet items in all relevant

cases, and not merely in the “extreme” situations noted in the Discussion Draft.

3. It is critical that internal transfers of risk that are effected on an arm’s length basis be respected.

4. The Discussion Draft should be revised to permit all of the profit or loss attributable

to an agency PE (for example, in a global dealing business, a PE that exists by reason of an affiliate exercising discretionary authority in respect of financial instruments that are booked in the name of an offshore principal) to be allocated to, and reported by, the dependent agent AE instead of the principal.

INSTITUTE COMMENCES LOBBYING EFFORT AGAINST NEW YORK STATE LEGISLATION THAT COULD ELIMINATE INTEREST DEDUCTIONS ON MANY ORDINARY COURSE BORROWINGS BY U.S. SECURITIES FIRMS AND OTHER NON-BANK SUBSIDIARIES FROM THEIR NON-N.Y. AFFILIATES

Executive Summary

The New York State budget legislation that was passed earlier this month contains a provision that could eliminate interest deductions on many ordinary course borrowings by U.S. securities firms and other non-bank subsidiaries from their non-New York affiliates. This legislation, which seeks to address concerns similar to those that prompted the federal “earnings stripping” proposals described above, seems to have been drafted without an adequate appreciation of the business operations of financial institutions, and therefore could have an unintended but severe adverse impact on U.S. subsidiaries of international banks.

While the legislation is poorly drafted, the intention is that this provision will apply to all corporations, including securities firms, regardless of whether they are subject to franchise tax under Article 9A (the State’s general corporate income tax) or under Article 32 (the State’s income tax on banking corporations).

The Institute is working to secure revision and/or clarification of this legislation to avoid these potential serious adverse consequences. Because the Legislature is scheduled to recess in a few weeks, the Institute does not expect to obtain a resolution of the problem until later this year, or possibly next year.

In general, under the legislation, a deduction is denied for interest payments made to a related member (determined after subtracting interest received from related members). While the legislation is poorly drafted, it appears that, for this purpose, an entity is a “related member” to another where there is a 30% direct or indirect ownership interest (measured by voting power or value) of

capital, profits or intangible assets between the two entities.

An exception is provided where

1. the transaction giving rise to the interest deduction was done for a valid business purpose (defined as a transaction not motivated primarily by tax avoidance

and where the transaction changes, in a meaningful way, apart from tax effects, the economic position of the taxpayer; a *rebuttable presumption* of tax avoidance exists if the majority of deductions generated by the transaction are not reportable as income in New York State by other taxpayers), **and**

2. either (a) the related member lender funds the transaction through unrelated party borrowings, or (b) the debt is part of a regular and systematic funds management or portfolio investment activity conducted by the related member, and in each case the related party transaction is at arm's length.

In the absence of clarification, the legislation could result in the disallowance of interest deductions on borrowings from affiliates that are not New York taxpayers including, significantly, (i) interest that is deemed to be paid on securities repo transactions and (ii) other funding received from affiliates that are not New York taxpayers.

The Institute is working to secure revision and/or clarification of this legislation to avoid these potential serious adverse consequences. Because the Legislature is scheduled to recess in a few weeks, the Institute does not expect to obtain a resolution of the problem until later this year, or possibly next year.

NEW REDUCED TAX RATE ON DIVIDENDS CREATES INTERESTING FINANCING OPPORTUNITIES

The tax legislation that was enacted this month reduces the maximum tax rate on dividend income (and long-term capital gains) of individuals to 15%, through the end of 2008. In general, this reduced tax rate applies to dividends received from a non-U.S. corporation if (i) the shares on which the dividends are paid (or ADRs relating to such shares) are traded on a U.S. securities market or (ii) the corporation is eligible for the benefits of a comprehensive income tax treaty with the United States containing an adequate information-exchange program and satisfactory to the IRS.

This reduced tax rate on dividends creates opportunities for tax-advantaged issuances of preferred stock that would be attractive to U.S. retail investors. Of particular interest to international banks is the potential to issue to U.S. retail investors Tier 1 capital securities, which may be structured as hybrid instruments so as to qualify (i) as equity for U.S. tax purposes, so that the current return payments would be treated as dividends eligible for the 15% tax rate in the hands of individual investors, and (ii) as debt for home country tax purposes, so that the current return payments would be deductible interest expense.

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