

WAYS AND MEANS INTERNATIONAL TAX REFORM DISCUSSION DRAFT

HEARING BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES OF THE COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES ONE HUNDRED TWELFTH CONGRESS FIRST SESSION

NOVEMBER 17, 2011

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WAYS AND MEANS INTERNATIONAL TAX REFORM DISCUSSION DRAFT

THURSDAY, NOVEMBER 17, 2012

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:00 a.m., in Room 1100, Longworth House Office Building, the Honorable Patrick Tiberi [chairman of the subcommittee] presiding.
[The advisory of the hearing follows:]

HEARING ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

Chairman Tiberi Announces Hearing on Ways and Means International Tax Reform Discussion Draft

November 26, 2011

Congressman Pat Tiberi (R-OH), Chairman of the Subcommittee on Select Revenue Measures, today announced that the Subcommittee will hold a hearing on the international tax reform discussion draft *released* on October 26, 2011 by the Committee on Ways and Means. The Committee released the discussion draft to solicit feedback on the details of the corporate rate cut and participation exemption (i.e., territorial) system that the Committee hopes to include as part of comprehensive tax reform. **The hearing will take place on Thursday, November 17, 2011, in Room 1100 of the Longworth House Office Building at 10:00 A.M.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing. A list of invited witnesses will follow.

BACKGROUND:

As part of its pursuit of comprehensive tax reform, the House Ways and Means Committee (“the Committee”) released on October 26, 2011, a discussion draft of one discrete component of broader tax reform legislation: a participation exemption for certain foreign-source income (sometimes referred to as a “territorial” system). The Committee released this draft because it views the participation exemption as a fundamental change in the way the United States taxes cross-border activity, and in the interests of transparency seeks feedback from a broad range of stakeholders, taxpayers, practitioners, economists, and members of the general public on how to improve this proposed set of rules.

The discussion draft is intended to be revenue neutral in and of itself when considered as part of comprehensive tax reform legislation that reduces the corporate tax rate to 25 percent. In addition to the exemption and other simplifications, the draft includes a number of options intended to prevent U.S. base erosion from activities such as overleveraging and income-shifting. Ways and Means Committee Chairman Dave Camp (R-MI) asked Chairman Tiberi to schedule a hearing on this discussion draft to begin to gather analysis from outside experts on the details of the draft.

In announcing the hearing, Chairman Tiberi said, **“The Members of the Ways and Means Committee worked hard to produce a draft proposal that encourages investment and job creation here in the U.S. while addressing concerns about potential erosion of the U.S. tax base through creative tax planning. Having said that, we want to ensure the plan carefully considers the potential impact on American businesses and workers, and we welcome feedback from the public on how to refine and improve the draft proposal.”**

FOCUS OF THE HEARING:

The hearing will focus on the Ways and Means discussion draft released on October 26, 2011. For purposes of this hearing, the Subcommittee is particularly interested in comments and analysis of the basic architecture of the draft exemption system, including the scope of the 95 percent exemption for certain dividends and capital gains, the treatment of different forms of entities and ownership structures, and the transition rule applied to pre-effective date earnings. The hearing also will re-

view the various options for protecting the U.S. tax base, both with respect to thin capitalization rules and income-shifting through the location of intangible property and similar means.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit written comments for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, <http://waysandmeans.house.gov>, select "Hearings." Select the hearing for which you would like to submit, and click on the link entitled, "Click here to provide a submission for the record." Once you have followed the online instructions, submit all requested information. ATTACH your submission as a Word document, in compliance with the formatting requirements listed below, **by the close of business on Thursday, December 1, 2011**. Finally, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225-3625 or (202) 225-2610.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word format and **MUST NOT** exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone, and fax numbers of each witness.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202-225-1721 or 202-226-3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Note: All Committee advisories and news releases are available on the World Wide Web at <http://www.waysandmeans.house.gov/>.

Chairman TIBERI. The hearing will come to order. Good morning, and thank you for joining us for another in a series of hearings on comprehensive tax reform.

At the Ways and Means Committee's first hearing this year, Chairman Dave Camp said that comprehensive tax reform would be a "long discussion." Last month, Chairman Camp initiated a new phase of this long discussion when he released his international tax reform discussion draft. I applaud Chairman Camp and his staff for their wonderful work in putting together a discus-

sion draft, and they should be also commended for the transparency in the process of doing it.

The purpose of the discussion draft is to gather feedback on how the Ways and Means Committee can best transition from a worldwide system to a territorial system of taxation. I look forward to gathering some of that feedback today with our witnesses. We are lucky to have before us a panel of some of the most well-respected international tax practitioners in our country.

In addition, I very much encourage practitioners, businesses, academics, and other interested parties, to share their feedback with us, as well. They can do so by visiting the comprehensive tax reform section of the Ways and Means Committee website.

And finally, I want to emphasize that comprehensive tax reform remains our goal. By the time we are finished, we will have reformed the Tax Code for all employers and all individuals.

I look forward to hearing from our witnesses today, and I now yield to my friend, Ranking Member Neal, for his opening statement.

Mr. NEAL. Thank you, Mr. Chairman. And I want to thank you for calling this hearing today to examine Chairman Camp's international tax reform discussion draft.

If there is one thing I think that we can all agree on, it is that our corporate and international tax rules need to be reformed. The United States has one of the highest statutory corporate tax rates in the world, which many economists say acts as a barrier to domestic investment.

We have also heard a lot about the so-called lock-out effect of high corporate tax rate, where U.S. multinational companies don't bring their earnings home to the United States because of the repatriations tax. At the same time, our current system includes loopholes which allow companies to shift income from the United States to low-tax or no-tax jurisdictions.

Therefore, I certainly commend Chairman Camp for releasing his international tax reform proposal. The Chinese philosopher noted that the journey of 1,000 steps begins with the first step. And I think Chairman Camp's proposal is a good first step, as I did with Mr. Rangel's proposal some years ago, as well. When that proposal was offered, I was always amazed at the hysteria that once again prevented us from having a conversation about what an international tax system ought to look like for the United States.

I think Chairman Camp should also be applauded for providing us what he envisions our new international tax regime to look like. I am also pleased that the proposal included approaches for preventing erosion of U.S. corporate tax base, the U.S. tax base, which is a critical concern as we move toward perhaps international tax reform.

That being said, I have an awful lot of questions about the chairman's proposal. For example, what impact would the proposal have on purely domestic companies and small businesses? Would the proposal encourage investment and job creation here, in the United States? Although I think lowering our corporate tax rate on a revenue-neutral basis is a worthy goal, can we lower the corporate rate to 25 percent without eliminating important tax incentives

that benefit job creation and investment in the United States like the R&D tax credit?

When it comes to lowering the top corporate rate to 25 percent on a revenue-neutral basis, Chairman Camp has given us a map without any street signs. So I am glad we are having this hearing today to examine the chairman's proposal, and I thank you and thank the witnesses for bringing the hearing forward. Thanks, Mr. Chairman.

Chairman TIBERI. Thank you, Mr. Neal. Before I introduce the witnesses, I ask unanimous consent that all Members' written statements be included in the record.

[No response.]

Chairman TIBERI. Without objection, we now turn to our witnesses and our panel, and welcome all of you today. I will introduce you all, and then we will start from left to right.

Mr. John Harrington is a partner with SNR Denton. Mr. Tim Tuerff is a partner with Deloitte Tax LLP. Mr. David Noren is a partner with McDermott, Will & Emery. Mr. Paul Oosterhuis is a partner with Skadden, Arps, Slate, Meagher & Flom LLP, and Dr. Martin Sullivan is a contributing editor with Tax Analysts.

Thank you, gentlemen. Mr. Harrington, you are recognized for five minutes.

**STATEMENT OF JOHN L. HARRINGTON, PARTNER, SNR
DENTON, WASHINGTON, D.C.**

Mr. HARRINGTON. Thank you, Chairman Tiberi. My name is John Harrington, and I am a partner at the law firm of SNR Denton. I appreciate the opportunity to appear before the Subcommittee on Select Revenue Measures to discuss the Ways and Means discussion draft released on October 26, 2011. The views expressed in this testimony are solely my own.

Before diving into the specifics of the discussion draft, I want to commend Chairman Camp and you all regarding the discussion draft. The materials released with the discussion draft included both statutory language and explanations of what is and is not in the discussion draft, facilitating understanding and scrutiny of the proposed participation exemption system.

This is not the standard way tax legislation is unveiled, but I believe that this is the right way to approach fundamental tax reform. We are often quick to complain about the legislative process, and so we should let you know when you get it right.

My written testimony goes into detail regarding various aspects of the discussion draft. In my oral testimony, I will highlight some of the major items.

Corporate rate reduction. The discussion draft would reduce the top corporate tax rate to 25 percent. I believe that a reduction in the corporate tax rate is a good idea for multiple reasons. I note, however, that reducing the corporate rate to 25 percent in a revenue-neutral manner would require a significant increase in the corporate tax base. Whether the prize is worth the cost can only be determined as the base-broadening proposals are identified and debated.

Regarding the basics of the participation exemption system, I believe that the discussion draft's participation exemption system is

a fundamentally sound starting point. I think there are significant advantages to using as a base the participation exemption system adopted by many other countries, rather than creating a new territorial system out of whole cloth. By using a frequently adopted system as a framework, it allows you to avoid the practical problems that would arise with an idealized but untested system.

The discussion draft includes certain rough justice rules. Although I may have suggestions to modify specific ones, I believe that, generally, rough justice rules are necessary. And much of the simplification advantages of the discussion draft are derived from such rough justice rules. For example, I believe that the discussion draft's choice to allow a partial 95 percent exemption and narrow expense allocation and disallowance rules is a better approach than a full exemption and more expansive expense allocation rules.

Treatment of branches of CFCs. Under the participation exemption system, foreign branches of U.S. corporations would be treated as controlled foreign corporations, or CFCs. I believe that this deemed CFC rule raises several practical concerns. In particular, I believe that the proposed threshold for deemed CFC status, the U.S. effectively connected income, or ECI, rule is both too transitory and too vague to serve as the necessary threshold. Not only would the deemed CFC rules require a domestic corporation to determine whether the ECI threshold has been crossed, it would require a domestic corporation to determine exactly when the threshold has been crossed.

Under the discussion draft, crossing the ECI threshold would result in the formation of a CFC, and the cessation of foreign activities would result in the demise of the CFC. In light of the technical problems of the deemed CFC rules, I strongly encourage you to consider allowing branches to be exempt without treating them as CFCs.

Treatment of 10/50 companies. The discussion draft provides an all-or-nothing election to treat 10/50 companies as CFCs. Domestic corporations will have to make the election if they want to keep the indirect foreign tax credit. Because electing 10/50 companies would become subject to subpart F, however, this election can raise serious questions about the shareholder's ability to get the information needed to comply with the myriad U.S. reporting rules. If you retain this rule, you will either have to simplify the information needed for subpart F, or have to deal with significant unintentional non-compliance.

Deemed repatriation. Any switch to a participation exemption system necessarily requires some rule to address old untaxed earnings of CFCs. The breadth and mandatory nature of the deemed repatriation rule raises several fairness issues, particularly with respect to individuals who would be subject to the deemed repatriation, even though they are not eligible for the participation exemption. If there are concerns about individuals, I suggest a more targeted rule.

Subpart F. A participation exemption system, where the question is whether to tax now or never, is fundamentally different than our foreign tax credit and deferral system, where the question is whether to tax now or later. Rules that were designed with deferral in mind have to be modified to reflect a different paradigm.

This is true not only for subpart F, but cross-border reorganization rules, transfer pricing, and other such rules.

In closing, I urge you, when you take up individual tax reform, to simplify and reform the international tax rules for individuals, as well. Many of the rules were designed with large businesses in mind, and they can be quite onerous on individuals and small businesses.

Thank you for the opportunity to present these views on the discussion draft. I would be happy to answer any questions that you may have.

[The prepared statement of Mr. Harrington follows:]

**STATEMENT OF JOHN L. HARRINGTON
BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
HEARING ON INTERNATIONAL TAX REFORM DISCUSSION DRAFT
NOVEMBER 17, 2011**

I. Introduction

My name is John Harrington, and I am a partner in the Tax Department of the law firm of SNR Denton. I appreciate the opportunity to appear before the Subcommittee on Select Revenue Measures to discuss the Ways and Means Discussion Draft released on October 26, 2011 (the "Discussion Draft"). The views expressed in this testimony are solely my own and are not on behalf of SNR Denton or any client of the firm.

II. Overview of Discussion Draft

A. Generally. My comments are focused on the structural and technical aspects of the participation exemption proposal set forth in the Discussion Draft. My comments are also based on my understanding that the 25% top corporate income tax rate and participation exemption set forth in the Discussion Draft would be part of a broad-based tax reform package. That tax reform package would include individual tax reform with base-broadening and a top rate of 25% along with corporate tax reform consisting of a 25% top corporate tax rate, fewer corporate deductions and exclusions, and a participation exemption system. The Discussion Draft is intended both to be revenue neutral overall from a corporate tax standpoint (i.e., the amount of corporate base-broadening that will be adopted is the amount necessary to achieve a 25% top corporate tax rate) and with respect to the taxation of foreign income specifically (i.e., the adoption of the participation exemption system and associated changes would raise the same amount of revenue as the current international tax rules). Accordingly, while the statutory corporate tax rate would be lower and the income eligible for the participation exemption would be 95% exempt, the overall effective tax rate on corporate income generally and on corporate foreign source income specifically would remain the same. Although the Discussion Draft at several points includes key percentages and numbers in brackets, indicating that final decisions have not been made about the bracketed numbers, for purposes of discussion, this statement assumes that the bracketed rate is the actual rate.

B. Components. As part of the Discussion Draft's participation exemption system,

- foreign-source dividends received by a 10% US corporate shareholder from a controlled foreign corporation ("CFC") would be eligible for a 95% dividends received deduction;
- gains from the sale of shares of a CFC by a 10% US corporate shareholder would be eligible for a 95% exclusion;
- losses on the sale of shares of a CFC by a 10% US corporate shareholder generally would be disallowed;
- foreign branches of US corporations would be treated as CFCs;
- US corporate shareholders that own 10% or more of a foreign corporation that is not a CFC (a "10/50 company") must make an all-or-nothing election whether to treat such 10/50 companies as CFCs; and
- expenses allocable to the exempt dividends or gains would not be deductible.

As a result of the new participation exemption system, significant modifications to the US foreign tax credit rules would be made:

- Generally no foreign tax credit would be available for amounts excluded by the participation exemption system (including for withholding taxes).
- The indirect (section 902) foreign tax credit for 10/50 companies and CFCs would be repealed. The indirect credit would only be available for subpart F income.
- The foreign tax credit baskets would be repealed, including for individuals and others not eligible for the participation exemption system.
- Foreign tax credit expense allocation rules would be significantly scaled back so that they apply only to directly allocable expenses. The new foreign tax credit expense allocation rules would also apply to individuals and others not eligible for the participation exemption system.
- The new foreign tax credit matching rule (section 909) would be repealed, including for individuals and others not eligible for the participation exemption system.

The participation exemption system assumes the adoption of provisions to prevent US tax base erosion and other perceived misuse of the new participation exemption system. The inclusion of such provisions are based on a policy rationale and to ensure revenue-neutrality. New rules for "passive income" would be adopted, using the current subpart F income rules as a base. Subpart F rules would be in some ways reduced (e.g., repeal of section 956), in other ways expanded (Subpart F would now apply to all 10/50 companies that are treated as CFCs), and no longer necessary rules removed (e.g., for previously taxed income).

III. Analysis of Discussion Draft

A. Process Regarding Discussion Draft. I want to commend Chairman Camp and the Ways and Means Committee Members for the way in which the issues raised by the Discussion Draft are being handled. First, the materials released with the Discussion Draft included both statutory language and explanations of what is and is not in the Discussion Draft, facilitating understanding and scrutiny of the proposed participation exemption system. Several aspects of the participation exemption system, particularly rates and percentages, are intentionally bracketed, signifying their tentative state. The Discussion Draft acknowledges the need for anti-abuse rules to protect the US tax base and offers three alternative approaches without expressing a preference for any option over the others. Finally, the materials released with the Discussion Draft encouraged comments on the proposal, including on particular aspects.

This is not the standard way tax legislation is unveiled, but I believe that this is the right way to approach fundamental tax reform. For a change of this magnitude, broad-based support is key. It would be a mistake to enact a system—even an ideal system—which is sufficiently misunderstood or opposed such that its repeal or substantial modification soon after enactment is likely. The changes set forth in the Discussion Draft are significant changes, and so it would be too disruptive to have their enactment be followed shortly by significant revisions or repeal—not because the original provisions were flawed, but because of a different make-up in a following Congress. Modifications (which will be necessary) should be to fix unexpected flaws, not to undo fundamental philosophical decisions. Nonetheless, it would be most unfortunate if this open process were to be used against the Discussion Draft. Critical but constructive comments are grounds to revise or reconsider elements of the proposed participation exemption system; they should not be viewed as ammunition against its consideration.

In addition, for purposes of an initial release, I believe that the proposed participation exemption system has the right amount of detail. Too little detail makes it impossible to evaluate intelligently the proposed

approach. On the other hand, too much detail may divert too much attention to the specific features of the proposed approach rather than to its basic features. Of course, the balance changes as the proposal evolves; presumably, future versions of the participation exemption system will be more detailed as you work through issues and receive comments on the Discussion Draft.

B. Basic Architecture of the Discussion Draft

1. Corporate Tax Rate Reduction. The Discussion Draft would repeal the current 34% and 35% corporate tax rates, leaving the 25% corporate tax rate as the top rate. Although this would be a substantial rate reduction for corporations with more than \$50,000 in income, it would put the US only in the middle range of advanced economies regarding top corporate tax rates. I will leave to others the economic consequences and political issues associated with a corporate tax rate cut, but I will note that the corporate tax rate reduction would be good from an international tax policy standpoint. First, to the extent that US corporate marginal rates are closer to the international norm, there will be less incentive and ability to shift income and activities to lower-tax countries, both because the "pay-off" is less and because there is a smaller pool of "low-tax" countries. Of course, generalizations are difficult in this area. First, countries have been changing their corporate tax rates, making detailed country comparisons often quickly out-of-date. Second, for many countries, the effective tax rate is much closer to the statutory rate, in contrast to the US where there is greater discrepancy between effective and statutory rates. Overly simplistic cross-country comparisons are therefore of limited value, despite their intuitive appeal. Nonetheless, even those who are not completely sold on a participation exemption system should evaluate a participation exemption system with a 25% corporate tax rate more favorably than a participation exemption system with a 35% corporate tax rate. For those who are worried that a participation exemption system will encourage US companies to shift activities offshore, the lower the US corporate tax rate, the less attraction that low-tax countries and deferral provide. They do not go away, but they play less of a distortive role.

The elephant in the room, of course, is how the 25% corporate tax rate would be obtained. A significant amount of the corporate tax base would have to be increased to achieve a 25% top rate in a revenue-neutral manner. Whether the prize is worth the cost can only be determined as the base-broadening proposals are unveiled. Simply put, this trade-off cannot be analyzed in the abstract.

2. Participation Exemption System. I believe that the Discussion Draft's participation exemption system is a fundamentally sound starting point. In particular, I commend its use of the participation exemption system used by many other countries as a base, rather than creating a new "territorial" system out of whole cloth. My primary basis for that conclusion is not because the participation exemption system approach is perfect. It has issues and I will discuss some of those issues. However, the issues are largely known. So, by using a frequently adopted system as a framework, it allows you to avoid the practical problems that would arise with an idealized (but untested) system. This approach makes sense in another fundamental way: To the extent that the changes made in the Discussion Draft are driven by competitiveness concerns, the changes should be consistent with other countries' approaches. Regardless of how one defines important but amorphous concepts like "competitiveness," I believe that we have to be more cognizant of what other countries do. We should not slavishly copy other countries' tax rules—this is not a question of whether the United States should be a leader or a follower regarding tax issues. Our tax system has to be designed to deal with our own specific issues and concerns. But some of the more recently-enacted changes to the U.S. international tax laws have not only been not consistent with what other countries have done, they have further isolated the US tax system from those of other countries. The tax rules of the US and other countries do have an effect on the location of international employment and activity, regardless of what we pretend or ignore.

The participation exemption system includes several "rough justice" rules, presumably in the interest of simplification. These rough justice rules include the partial disallowance but narrower expense allocation rules, the formulaic determination of the "foreign-source portion" of dividends, and the use of the current section 902 rules to define 10/50 companies. One can argue with aspects of these rules, and I expect that some or all will be modified in response to comments or revenue concerns. Nonetheless, putting the specific details of the simplifying compromises aside, I believe that rough justice rules are necessary. Much of the simplification advantages of the Discussion Draft come from such rough justice rules. For example, one could argue for a full (rather than 95%) exemption and more theoretically pure expense allocation rules. That approach would be more technically correct but also much more complex. This is particularly an instance in which we can benefit from other countries' experiences, several of whom have adopted such a partial disallowance rule to serve in lieu of more detailed expense allocation rules.

C. Specific Issues. The rest of my statement addresses specific issues in the Discussion Draft. I will focus first on aspects of the participation exemption proposal that have significance going forward. I refer to these as "design issues." Second, I will discuss the aspects of the participation exemption proposal that are temporary or transitional in nature. I refer to these as "short-term issues." Finally, I will discuss international tax issues that are related to the participation exemption system but which impact other international tax rules as well. I refer to these as "interactive issues." Finally, even when I note specific problems or issues with an aspect of the participation exemption system, I have tried not to express outright opposition to the aspect of the proposal in this statement. That is because I recognize that if the Discussion Draft is to be kept revenue-neutral, getting rid of one revenue-raising (or anti-abuse) provision necessarily requires its replacement with an offsetting change in the proposal. Those sorts of trade-offs seem to be more appropriate at a later stage in the development of the Discussion Draft.

1. Design Issues

i. Treatment of branches as CFCs. A foreign branch of a domestic corporation is defined as "any trade or business of such domestic corporation in a foreign country." The technical explanation released with the Discussion Draft states that "It is intended that the rules and principles applicable in determining whether a foreign corporation is engaged in a U.S. trade or business govern whether foreign business operations constitute a foreign branch." If I understand the rationale for this rule, then absent a provision that automatically treated branches as CFCs, domestic corporations that can operate in foreign subsidiary form could elect whether they wanted a specific foreign operation to be subject to the participation exemption system or the foreign tax credit rules. Although we tax practitioners instinctively like electivity, I assume that the Discussion Draft seeks both to apply the participation exemption system to branches and to prevent electivity for both policy reasons (because the participation exemption system is intended to be the normative method of taxing active foreign income of a domestic corporation) and revenue reasons (since electivity generally has negative revenue consequences as taxpayers are assumed routinely to elect the lower-tax option).

Nonetheless, I believe that this deemed CFC rule raises several practical concerns. First, treating a branch as a CFC raises administrative difficulties. The rule requires taxpayers to determine the income of an "entity" that is not a real entity. Granted, taxpayers encounter this problem currently in the context of US tax treaties, particularly in those tax treaties that require calculation of the income of a permanent establishment as though it were a separate, independent entity. In most cases, however, the US tax rules regarding source of income and expense allocation operate in such a manner that this separate entity construct is not really put to the test. It is important to note that this problem goes well beyond the issues raised by disregarded entities. Although a disregarded entity is not taxed separately from its owner, the disregarded entity at least exists as a separate legal entity and thus results in a record of transactions between the disregarded entity and related and unrelated parties. In that case, actual as

opposed to merely deemed transactions between legal entities have occurred, even if one of those entities is disregarded for US tax purposes.

Aside from the practical problems of constructing an otherwise non-existent CFC, the proposed threshold for deemed CFC status is problematic. The practical concerns are two-fold. First, I believe that the US effectively connected income ("ECI") rule is both too transitory and too vague to serve as the necessary threshold. Determining when a foreign person has engaged in both the type and quantity of actions in the US sufficient to cross the ECI threshold is fact-specific and requires judgment calls. In contrast to the current ECI determination, under the deemed CFC test, one would be applying this rule in the outbound rather than inbound context. That means applying it in a less familiar context. That in and of itself is not fatal, but it makes a currently subjective test even more judgment-filled. The bigger problem, however, is not merely that the deemed CFC rule requires one to determine whether the ECI threshold has been crossed--it requires one to determine exactly when the threshold has been crossed. In the current ECI context, the issue generally relates to how much US-source income of a foreign person is subject to US income tax as a result of that foreign person's US activities. Under the Discussion Draft, crossing the ECI threshold would result in the formation of a CFC and the cessation of foreign activities would result in the demise (liquidation?) of a CFC. So, the date at which the threshold was passed becomes very important since the US tax rules that apply to transfers to and from a CFC become applicable as of that date. The date on which the ECI threshold ceases to be met would be very important as well since that would presumably result in the liquidation of the CFC, with the attendant US tax consequences. Granted, the participation exemption rules could be modified or clarified to prevent this deemed liquidation result and therefore not consider the deemed CFC liquidated until the taxpayer affirmatively takes a specific action to do so. But that would mean, for domestic corporations that begin and cease activities in a foreign countries, defunct deemed CFCs loitering in countries around the world. Treating a branch as a CFC would also subject the deemed CFC to the normal US tax rules that apply to CFCs, such as the gain recognition rules that apply to outbound transfers (section 367) and the requirements to keep E&P and other records. For domestic companies that are just entering new markets or domestic companies that periodically enter and exit foreign markets, these rules will be burdensome.

Note that the significance of this deemed CFC rule will be greatly influenced by whether (and the extent to which) current entity classification rules are retained or modified. With current check-the-box rules, taxpayers that prefer to operate in subsidiary form in a foreign country can often elect to have their foreign subsidiaries treated as disregarded entities and therefore considered branches for US tax purposes. Thus, the frequency with which the deemed CFC rule would apply will be affected by the ease with which (for US tax purposes) the domestic corporation can operate in branch form. Despite their significance in this case, the entity classification rules will not be discussed further since they are more relevant in other aspects of tax reform, such as subpart F.

From a policy and revenue standpoint, limiting electivity by imposing the deemed CFC rule is understandable. However, electivity will remain, depending on how the participation exemption system treats domestic corporations operating in a foreign country in partnership form. Unless the bracketed language in new section 245A(b)(2)(C) is adopted and the Treasury Department issues regulations, a domestic corporation can avoid the deemed CFC rules by operating its branch through a controlled partnership. Of course, you could seek to stop that by treating all controlled partnerships as CFCs, but expanding the deemed CFC rules to partnerships would exacerbate the problems described below regarding 10/50 companies. Similarly, in the case of an individual, the electivity exists in the sense that the individual can choose whether to structure foreign investment through a domestic corporation or directly (or through a pass-through entity, depending on how partnerships are treated under the deemed CFC rules).

These concerns are sufficiently great that I encourage you to reconsider the deemed CFC rules or at least modify the standards and thresholds. From both a policy and fairness standpoint, US companies that operate in branch form should be eligible for the participation exemption system if it is provided to those US companies with foreign subsidiaries. In light of the technical problems of the deemed CFC rules (e.g., the uncertainty as to when a deemed CFC is created and terminated, the host of US tax rules that would apply to the intra-company transfers to and from the branch, and the difficulty in constructing the income of an otherwise non-existent entity), I strongly encourage you to consider allowing branches to be exempt without treating them as CFCs. Of course, I recognize that this has revenue consequences and, if the participation exemption is kept revenue-neutral, will necessitate revisiting other aspects of the participation exemption system (such as the expense allocation rules) and considering offsetting revenue-raising changes.

ii. Treatment of 10/50 companies as CFCs. The Discussion Draft provides an all-or-nothing election to treat 10/50 companies as CFCs. For most domestic corporations, this appears to be an offer that they can't refuse: there are big consequences if a domestic corporate shareholder fails to make this election, primarily the loss of the indirect foreign tax credit. Nonetheless, because electing 10/50 companies would become subject to subpart F, this election can raise serious questions about the shareholder's ability to get the information needed to comply with the myriad US reporting rules. In practice, the relevant information is often hard enough to get currently from CFCs. The information generally requires calculations and information that is not needed for local (foreign) tax law purposes, and the people necessarily tasked with obtaining the information from the CFC may be unfamiliar with US tax law and principles. Accordingly, it is not clear how shareholders in foreign-controlled 10/50 corporations will be able to get this information. If you retain this rule, you will either have to simplify the information needed for subpart F or have to deal with significant unintentional noncompliance. For example, what happens if the noncontrolling shareholder makes this election, uses every means at its disposal, but does not have the power to compel the needed information? Is the shareholder's only choice either to report incompletely or to sell its interest in the foreign corporation? It is not sufficient simply to warn companies that they should not make this election unless they are confident that they can meet the rule's requirements. What if a domestic shareholder makes the election, certain that it can meet the subpart F reporting requirements based on its initial holdings, but then years later acquires a 10% or greater (but not controlling) interest in another foreign corporation, and can no longer meet the reporting requirements? At the end of the day, if you want compliance, the subpart F rules will have to be something that the electing companies can realistically meet. The subpart F rules are an issue for a later hearing, but this issue is relevant in evaluating this treatment of 10/50 companies as CFCs.

iii. Treatment of partnerships. The difficult issue as to how to treat branches operated in partnership form is understandably left to regulations. Until such regulations are issued, however, partnerships will not be subject to the deemed CFC rule, and it is hard to see how a regulatory rule can be developed that catches all operations without being overly broad. This means that, at least initially, the partnership's activities will be considered to be conducted directly by the corporate partners and will not be subject to the participation exemption system, potentially creating discontinuities in the new rules for domestic corporations. This result will certainly undercut the proposal's treatment of branches as CFCs generally. In any case, because the participation exemption system applies only to domestic corporations, partnerships with both corporate and non-corporate partners will need to report information under both the participation exemption system and the foreign tax credit rules that continue to apply to individuals.

iv. Items repealed (section 956, multiple baskets, etc.). The repeal of certain foreign tax credit rules (e.g., separate basket treatment and detailed expense allocation rules) and rules related to repatriation of foreign income (e.g., section 956 and section 959) are sensibly repealed in the

context of the participation exemption system, and their repeal provides a welcome simplification. Nonetheless, the foreign tax credit rules continue to apply to individuals since individuals are not eligible for the participation exemption system. So, increased cross-crediting and foreign tax credit "splitter" transactions will be available to individuals. However, considering the smaller universe of foreign tax credit recipients as a result of the participation exemption system, the reduction in the government's ability to prevent foreign tax credit misuse may be outweighed by the benefits of the reduced complexity. This is not to say that none of these foreign tax credit rules should be retained. Rather, from a simplification standpoint, it is better to ask "what should be added back" rather than "what in current law should be retained?"

v. Base erosion. The Discussion Draft includes provisions to prevent what it terms "base erosion."

First, for US companies with foreign affiliates (i.e., a "worldwide affiliated group"), "thin capitalization" rules would disallow a portion of net interest expense of the US members of the group if the US members of the worldwide affiliated group fail a debt-to-equity differential test and the US companies' net interest expense exceeds a (currently unspecified) percent of adjusted taxable income. This test is mechanically complex, and to evaluate it one would need to know the specific percent of adjusted taxable income to be used as a threshold. As a conceptual matter, adopting or strengthening a thin capitalization rule is not objectionable, especially in conjunction with adoption of a participation exemption system, but whether the thin capitalization rule is administrable and whether it is broader than necessary will depend on the details. Although the provision is limited to domestic groups, non-US companies will wonder whether this test will also be incorporated into section 163(j) and therefore apply to them.

The Discussion Draft floats three possible anti-abuse options (labeled Options A, B, and C):

- The proposal by the Obama Administration to tax "excess returns" from transfers of intangible assets to low-taxed affiliates. This rule would include the subpart F portion of the Administration's budget proposal. Compared to the other options, the Administration budget proposal has received a lot of analysis, and so my remarks will be limited to noting that it is both conceptually and mechanically complex. This option does not include the Administration budget proposal's separate foreign tax credit basket rule, and that omission is sensible considering the Discussion Draft's repeal of the separate foreign tax credit baskets.
- A proposal to treat "low-taxed cross border income" as subpart F income. This rule would use a presumptive effective tax rate of 10% as the test for whether the income is low-taxed. If the income is low-taxed and earned outside the CFC's home country, the income would be subject to immediate US tax, although the income would be eligible for foreign tax credits. This basic approach of excluding certain low-taxed income from the participation exemption system is used by several other countries. Adoption of this rule would from a US standpoint reflect a philosophical shift, however. Our anti-deferral rules have historically targeted passive and easily moveable income, although high-tax exceptions often apply. Ignoring revenue consequences for a moment, the fundamental question is whether the participation exemption system is intended to apply only in instances of significant double taxation, in which case application of the participation exemption system would turn on whether the source country has taxed the income enough as far as the US is concerned. How significant (i.e., how burdensome, how behavior-affecting) this provision would be depends on what the effective tax rate test would be. This rule will not be easy to administer or comply with. Determining the applicable effective tax rate is difficult and so, except for countries that are very high-tax or very low-tax, it will be difficult to determine in advance whether income is subject to this rule. This is not just an issue of looking at a country's statutory rates---timing and base differences will be

just as important. Current subpart F rules that use effective rate tests, such as section 954(b)(4), are notoriously difficult to apply in practice.

- A proposal to subject foreign intangible income to immediate US tax as subpart F income but at a special lower rate (presumptively 15%). This option is described in the three-page summary as "combin[ing] the carrot of an 'innovation box' and royalty relief with the 'stick' of a current (subpart F) inclusion for intangibles-related income of CFCs in low-tax jurisdictions." This proposal does not pose many of the administrative problems of the first two options. However, as with the "low-taxed cross border income" proposal, this would represent a philosophical shift in US taxation, treating income that is unquestionably "active" under current standards as subpart F income and therefore subject to US tax. The primary basis for the lower rate on such immediately taxable income seems to be mainly as a palliative for the acceleration in taxes (in addition to rewarding those that keep the intangible property in the US and use or license it abroad). Special rules applicable to intangible income are understandable, particularly in light of reports of US-controlled companies shifting or developing intangible assets in low-tax jurisdictions to reduce their worldwide effective tax rate. Frustration over the inability to tax foreign intangible income does not appear to be a solid basis for singling out such income for immediate taxation though.

2. Short-term issues

i. Deemed repatriation. Any switch to a participation exemption system necessarily requires some rule to address "old" untaxed earnings of CFCs. These amounts would have been subject to US tax as dividends when paid (or deemed paid) to a domestic corporate shareholder. One option is to apply the participation exemption rules to pre-existing earnings, i.e., to exempt any dividend paid (or deemed paid) by the CFC to a domestic corporate shareholder, regardless of whether the earnings are attributable to periods preceding the adoption of the dividend exemption system. This is the simplest approach, but I assume that this option was rejected on revenue grounds. Not only would it exempt pre-existing earnings from US tax (with the corresponding revenue effects), but CFCs that could defer paying dividends would presumably delay paying dividends out of low-taxed earnings prior to the effective date of the participation exemption system. So, I can see why this potential freezing effect on payment of dividends might cause one to avoid including such a rule in the Discussion Draft, even as an option. A second basic option is to require CFCs to maintain pre-existing E&P and tax pools and to impose US tax (subject to the section 902 credit) on dividends to the extent of those "old" earnings. This would require domestic corporations and CFCs to maintain procedures to deal with both the old and new rules indefinitely. That would defeat a significant portion of the simplification advantages of the participation exemption system. The third basic option is to cause, either voluntarily or involuntarily, a repatriation of the old earnings. The Discussion Draft adopts a variation of this third option, causing the subpart F income of a 10-percent owned foreign corporation to be increased by the accumulated deferred foreign income of such corporation. A US shareholder with respect to the foreign corporation would be eligible for a 85% exclusion of the deemed income. Affected shareholders could elect to spread the payment of the US tax (with interest) on the deemed repatriation over 10 years. Unlike the participation exemption, this deemed repatriation and exclusion would apply to all U.S. shareholders, including those that are individuals.

The breadth and mandatory nature of the deemed repatriation rule raise several fairness issues. First, is it appropriate to require income recognition of "old" income by U.S. shareholders, even though they have not received this income (and may not, especially in the context of 10/50 companies, even be able to compel its distribution to them) and this income has not run afoul of any existing or previous anti-deferral rules? Second, is it fair to tax this amount at a preferential rate? Third, if one answers the first two questions affirmatively at least with respect to domestic corporations, is it appropriate to subject non-corporate shareholders to this deemed distribution? The rationale for the deemed distribution (whether

one agrees with it or not) seems to be to clear out the old earnings so that the participation exemption system will govern all future income and distributions of CFCs to domestic corporate shareholders. On the other hand, US persons who are not treated as corporations will not receive the benefits of the participation exemption system (discussed further below), making it unclear why they should be subject to the deemed repatriation. Some individuals, if offered an 85% exemption, would voluntarily bring back all of their foreign corporate earnings. Others would not have made that choice and may not even find it feasible to bring back more than a small fraction of the deemed repatriation. Accordingly, the fairness concerns raised by the deemed repatriation are magnified for individuals. If individuals remain ineligible for the participation exemption, their being subject to the deemed repatriation should be reconsidered at least on its current terms. If the concern is that individuals may, post-effective date, transfer their CFC and 10/50 company stock to a domestic corporation and therefore obtain the participation exemption on the "old" earnings of their CFCs and 10/50 companies (which would have been taxable as dividends if they continued to hold the stock directly), that concern would be better addressed through a more targeted rule limited to such post-effective date transfers to a domestic corporation.

ii. "Old" foreign tax credit issues.

a. Overall domestic losses ("ODLs") and overall foreign losses ("OFLs").

In the context of a move to a participation exemption system, I would recommend elimination of ODL and OFL accounts, at least with respect to general basket income and taxes, and certainly for domestic corporations that use the participation exemption system. The broader the coverage of the participation exemption system (e.g., if it is expanded to partnerships and/or individuals), the stronger the argument for repealing these rules in their entirety for all taxpayers. In any case, with the repeal of the separate baskets, the separate limitation loss rules (including separate limitation loss accounts) should be repealed for everyone.

b. Foreign tax redeterminations and foreign tax refunds. Depending on how willing policy makers are inclined to rough justice, foreign tax redeterminations and refunds could be ignored.

c. Foreign tax credit carryovers. The Discussion Draft provides regulatory authority for carrybacks of foreign taxes. With respect to foreign tax credit carryforwards, for many domestic corporations subject to the participation exemption system, the amount of future taxable foreign income and creditable taxes will be tied to how robust the subpart F rules will be. If corporate taxpayers will have little opportunity to use foreign tax credit carryforwards due to the treatment of old earnings and taxes (e.g., old earnings could not be used to absorb foreign tax credits under the deemed repatriation proposal), a rough justice approach will be appropriate.

iii. Existing tax treaties. Existing US tax treaties provide relief from double taxation through the foreign tax credit. Notwithstanding the statutory denial of foreign tax credits in the context of the participation exemption system, unless the new legislation overrides the tax treaties, US companies may still be able to elect foreign tax credit treatment if the treaty so provides (Article 23, the usual article addressing double taxation, is typically an exception to the "savings" clause in US tax treaties, although one would have to examine the specific wording of each treaty to determine what rights the taxpayer has). Although I am usually a strong opponent to legislative overrides of US tax treaties, this is an exceptional case, dealing entirely with the US taxation of its residents. The proposed change in the US method of relieving double taxation would not disturb the balance of benefits and burdens to which the two countries agreed when negotiating the tax treaty. Accordingly, it is reasonable to require US taxpayers subject to the participation exemption system to use that system rather than the foreign tax credit system, notwithstanding an applicable tax treaty. To the extent that US taxpayers would be

electing to use US domestic law (i.e., the new participation exemption system), rather than the foreign tax credit in the tax treaty, the legislation would need to make clear that this is okay and not the "selective mix-and-matching" of treaty and domestic law benefits. See e.g., the Technical Explanation to the 2006 U.S. Model Income Tax Convention (Article 1(2): "A taxpayer may not, however, choose among the provisions of the Code and the Convention in an inconsistent manner in order to minimize tax."). Going forward, the U.S. Model Income Tax Convention would have to be revised to reflect the participation exemption system. This should not be too onerous since many non-US tax treaties already address this issue.

3. Interactive issues

i. Subpart F. The three-page summary released with the Discussion Draft notes that the Discussion Draft does not generally address "subpart F changes, including with respect to recapture accounts" and specifically requests comments. Irrespective of any other changes made to subpart F as part of the broader tax reform, subpart F plainly needs to be revised to reflect the participation exemption system, at least for corporate shareholders of CFCs. The subpart F rules were designed as an anti-deferral regime, and certain rules governing non-passive income, such as the inclusion of foreign-to-foreign sales and services in foreign base company income are out-of-place in a CFC regime in the context of a participation exemption system. There is a rationale (although to me, weak) for including such income in subpart F in our current anti-deferral context when the issue is whether to tax the income now or later. Treating such income as non-exempt makes little sense and reduces the potential simplification of the participation exemption system.

ii. Dual consolidated losses and cross-border reorganizations. Like subpart F, one needs to revisit the US tax rules that were designed with deferral in mind and modify them to reflect a participation exemption system. The gain recognition agreement rules of section 367(a), which in certain cases require gain recognition only if certain events happen within a five-year period, may be viewed as a model for dealing with many of these rules. One would hope that the denial of losses and deductions related to participation exemption income would allow substantial simplification of the dual consolidated loss rules.

iii. Effect of changes on individuals. This is one of the most difficult aspects of the Discussion Draft. Part of the difficulty lies in that we are seeing only part of the tax reform package: the participation exemption system is intended to be part of a broader tax reform plan that includes substantial changes to individual income tax rates, deductions, exclusions, and exemptions. Accordingly, it is not clear to a reader whether the limitation of the participation exemption system just to corporations reflects a policy decision to limit it just to corporations or whether it reflects the fact that the Discussion Draft deals only with the participation exemption in the corporate context. In any case, the participation exemption system in the Discussion Draft is based on the dividends received deduction (which applies only to corporations), and so individuals are excluded from the 95% exemption. I understand that limiting the participation exemption just to corporations is common in other countries with participation exemption systems, and so a participation exemption system limited to corporations is within the international norm. The US, however, is unusual in the extent to which business income is taxed at the individual level (i.e., the ubiquity of pass-through entities in the US), and so this distinction will have greater significance in the US than in many other countries. At the same time, the changes to the foreign tax credit (which generally significantly loosen the foreign tax credit rules) that would be made by the Discussion Draft would apply to individuals as well. So, from an individual standpoint, the impact of the Discussion Draft is mixed: individuals would benefit from the foreign tax credit changes, be impacted by the base erosion changes (whichever option is adopted, provided the new rules are based on subpart F), and be left out of the participation exemption system. Individuals who own CFCs or own interests in 10/50 companies that are

partly owned by domestic corporations, however, would be directly impacted by the deemed repatriation proposal. This raises significant questions (discussed above) both of fairness and intended effect.

As for the treatment of individuals in the participation exemption system generally, to the extent that the participation exemption system is based on motives of simplification and competitiveness, expansion of the participation exemption to individuals should be considered, whether as part of the participation exemption system generally or in the context of other individual tax reforms. The significance of this issue of course depends very much on the other changes in the overall tax reform package: the difference (if any) between corporate and individual tax rates, how dividends from domestic corporations are treated, whether the availability of pass-through entities is circumscribed, whether the US changes its basis of taxation (e.g., to a residence basis like that used in most of the world). More generally, I encourage you to consider, in the course of examining individual tax reforms, relief for US individuals with foreign source income (whether US-based individuals or, even more, US citizens living and working outside the US). The filing and recordkeeping rules for such individuals can be quite onerous, and many do not have bookkeeping and accounting infrastructure that businesses do.

IV. Conclusion

Thank you for the opportunity to present these views on the Discussion Draft. I would be happy to answer any questions you may have.

Chairman TIBERI. Thank you, Mr. Harrington. You got a lot of information in that 5 minutes with about 10 seconds to spare. Thank you so much.

Your work is cut out for you, Mr. Tuerff. You are recognized for five minutes.

**STATEMENT OF TIM TUERFF, PARTNER, DELOITTE TAX LLP,
WASHINGTON, D.C.**

Mr. TUERFF. Mr. Chairman, Ranking Member Neal, and Members of the Subcommittee, thank you for the opportunity to share my views on the discussion draft for establishing a territorial system for taxing foreign income. I am a tax partner with Deloitte Tax LLP, with over 27 years of experience as a tax attorney and CPA. I appear today on my own behalf, not on behalf of Deloitte Tax or a client of Deloitte. I am honored to be present and to participate in this hearing.

U.S. corporations are taxed on their worldwide income, and are allowed a credit for foreign income taxes. This system is different from the territorial tax system used by almost all other OECD countries, which exempt foreign income from domestic corporate tax.

Most recently, Japan and the United Kingdom adopted territorial systems of taxation. The use of territoriality by our competitors, along with the higher U.S. corporate tax rate has given serious concern about U.S. competitiveness. In my oral testimony today, I would like to discuss a proposed deemed dividend deduction, and the expansion of subpart F.

An exemption system is a more competitive alternative to the current U.S. tax regime. The high U.S. corporate tax rate results in an increased tax charge on repatriation of earnings from foreign subsidiaries. This additional charge causes what is often referred to as a lockout of foreign earnings, preventing them from being returned to the United States. The proposed 95 percent dividends received deduction would reduce the U.S. tax charge on remitted earnings to 1.25 percent, thereby allowing for the movement of capital back to the United States for reinvestment in domestic operations.

Furthermore, an exemption system would simplify U.S. tax law by significantly reducing the importance of the foreign tax credit. Under the discussion draft, the foreign tax credit would be primarily relevant to subpart F income and withholding taxes on interest and royalties. Only one foreign tax credit limitation would be needed, and only directly allocable expenses would reduce that limitation.

The proposal raises the question of whether deductions should be allowed for expenses attributable to exempt foreign income. The discussion draft follows the position adopted in a number of countries which reduce the amount of the exemption, typically to 95 percent, as a reasonable proxy for disallowing expenses incurred in the domestic country attributable to exempt foreign income.

The deductibility of expenses is a factor in retaining and expanding corporate headquarters functions in the United States. By comparison, United Kingdom adopted a 100 percent exemption for active foreign income, and did not place any restrictions on deductions. This change was adopted to encourage performance of corporate activities in the United Kingdom.

Moving on to subpart F income, the discussion draft includes three options for significantly expanding the existing subpart F rules. The proposed options A and C require CFCs to bifurcate their sales and services income between intangible related returns

and non-intangible related returns. I know of no other country that does this. The bifurcation of intangible income requires taxpayers to unscramble the economic egg by identifying the amount of revenue and expenses attributable to intangible property, compared with other functions of the CFC.

Requiring segregation of return from intellectual property will result in significant controversy during the examination process, as taxpayers and the IRS attempt to subdivide returns on transactions. Such a theoretical subdivision of a single transaction is considerably more complex than adjusting a transfer price for an actual transaction.

Historically, our subpart F rules have focused on whether income was derived from an active conduct of a trade or business. If any of these options were enacted, it would represent the first time that subpart F rules would look to foreign tax rates for purposes of defining when a CFC's earnings should be currently taxed in the United States.

Option A, in addition, has the novel feature of focusing on the CFC's rate of return on expenses. By triggering current taxation when the return exceeds 150 percent, option A encourages taxpayers to push deductible development and marketing costs into the CFC, which is inconsistent with the policy objective of the subpart F provisions.

Under current law, the CFC must pay for the right to use its U.S. parent's intellectual property outside the United States. These proposals would treat income from active business operations as subpart F income, solely on the basis of intangible property that was acquired in arms-length transactions. This treatment is inconsistent with the arms-length standard, the cornerstone of international taxation for members of the OECD.

In conclusion, I hope my comments on these proposals are constructive, and I look forward to addressing your questions. Thank you.

[The prepared statement of Mr. Tuerff follows:]

TESTIMONY OF T. TIMOTHY TUERFF
TAX PARTNER, DELOITTE TAX LLP
ON
DISCUSSION DRAFT PROVISIONS TO ESTABLISH
A PARTICIPATION EXEMPTION SYSTEM
FOR THE TAXATION OF FOREIGN INCOME

BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES OF THE
HOUSE COMMITTEE ON WAYS & MEANS

November 17, 2011

Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to share my views on the discussion draft for establishing a territorial system taxing foreign income. I am a Tax Partner with Deloitte Tax LLP with over 27 years of experience as a tax attorney and CPA. I am the head of Deloitte's Washington National Tax International Tax Services group, which serves multinational clients engaged in international business. My practice has largely focused on serving U.S. based multinational enterprises conducting business operations outside the United States. I appear today on my own behalf, and not on behalf of Deloitte Tax or a client of Deloitte. I am honored to have been invited to participate in this hearing.

Chairman Camp's discussion draft takes an important step in proposing changes to the U.S. tax rules dealing with international business operations. Congress last substantially revised these rules in 1986. During the 25 years since then, additional restrictions have been placed on the foreign tax credit mechanism resulting in a very complex and burdensome regime. This regime

places an unacceptable strain on both taxpayers in computing and reporting their tax liability and on the IRS and Treasury in administering these provisions.

Important Role Territoriality Plays in the Global Tax System Today

The United States employs a worldwide system for taxation of business income. U.S. corporations generally are taxed on their worldwide income, regardless of where the income is earned, and are allowed a credit for foreign income taxes, limited to 35% of their net foreign-source income. Income earned by foreign subsidiaries from active business operations conducted outside the United States is generally not subject to U.S. tax when it is earned. However, U.S. tax is imposed at the time when the earnings are repatriated to the U.S. parent corporation. Foreign income taxes associated with the repatriated earnings become creditable against the parent's U.S. tax liability. Under the rules of subpart F, U.S. parent corporations pay U.S. tax on certain types of income (generally, passive income or income thought to be easily movable), earned by their controlled foreign corporations (CFCs) regardless of whether or not it is repatriated.

Historically, most of the major capital-exporting nations also employed a worldwide system. But with the dramatic global economic changes of the last 50 years, countries have changed their international tax systems, citing competitiveness concerns. Today, almost all other countries that belong to the OECD have some form of a territorial system. These systems generally exempt foreign income from domestic corporate tax, subject to varying restrictions. Most recently, Japan and the United Kingdom adopted territorial systems of taxation. These movements to

territoriality by our competitors and the relatively high U.S. corporate income tax rate have given rise to serious concerns about competitiveness of U.S. firms. These concerns led to the territorial proposal put forth by Chairman Camp on October 26th of this year. I would like to focus on the impact of the following aspects of the discussion draft:

- Participation Exemption for Foreign Income;
- Deductible Expenses;
- Expansion of Subpart F;
- Transfer Pricing;
- Branches;
- 25% Corporate Tax Rate; and
- Transition Rules.

I. Participation Exemption for Active Foreign Source Income

The discussion draft proposal provides a 95% dividends-received deduction for foreign-source dividends from CFCs, subject to a 365 day holding period. This 95% exemption is similar to the territorial system used by France, Germany and Japan. The United Kingdom recently adopted a territorial system with respect to dividends. This system generally provides for a 100% dividend exemption for dividends received after July 1, 2009 from foreign subsidiaries.¹ The United

¹ The United Kingdom could deny the 100% exemption under an anti-abuse rule where dividends are treated as deductible expenses for local law purposes.

Kingdom's stated motivation for the adoption of this system was to make the United Kingdom a more desirable location in which to organize and operate a corporate residence.²

A participation exemption system is a more competitive alternative to the current U.S. regime that imposes a residual level of U.S. tax on the remittance of foreign earnings back to the United States. The current corporate tax rate of 35% coupled with lower tax rates imposed outside the United States result in an increased tax charge on repatriation of earnings from foreign subsidiaries. This additional charge causes what is often referred to as a "lockout" of earnings, preventing them from being returned to the United States. The proposed 95% dividend exemption system would reduce the U.S. tax charge on remitted earnings to 1.25%, thereby allowing for the movement of capital back to the United States for reinvestment in domestic operations.

The location of business operations in an offshore market is necessary to meet the needs of a global customer base. U.S.-based companies must conduct business outside the United States in order to expand their businesses and stay competitive. Even mid-sized companies find that the growth of business opportunities often requires expansion into non-U.S. markets. In a global economy, companies must address the needs of their current and future customers, regardless of

² See The Independent, March 25, 2008, "Taxation: Foreign Dividends Exempted" by Nick Clark (quoting Alistair Darling, the UK Chancellor at the time the dividend exemption was announced, as stating: "I will maintain a focus on the long-term competitiveness of the UK and to increase our attractiveness as a base for global businesses. To do so, I will introduce an exemption for foreign dividends in 2009 for large and medium businesses, and improve our rules for taxing Controlled Foreign Companies"). The primary motivation for Japan in introducing the 95% dividend exemption, as stated by its Ministry of Finance, was to encourage repatriation of foreign profits. See Japanese Ministry of Finance, "Heisei 21 Nendo Kaisei Zethou No Subete" (An Overview of the 2009 Tax Reform), p. 425, "— Gaikoku Kogaisha Haitou Riekinin Fusammyuu Seido No Dounyuu — 1. Seido Dounyuu No Keit/Shushi" (1. Introduction of the system for excluding dividends from a foreign subsidiary — 1. Background and purpose of the introduction of the system).

location. An exemption system facilitates the ability of U.S. companies to address the needs of foreign markets while retaining support operations in the United States. Under this system funds may be earned outside the United States and remitted to the United States to pay for research and development and corporate headquarters expenses.

Finally, the enactment of a territorial system will simplify U.S. tax law by significantly reducing the importance of the foreign tax credit. Limiting the use of the foreign tax credit system as the primary means of preventing international double taxation will reduce the burden of expense allocation and the other complex provisions designed to ensure that foreign tax credits do not shelter U.S. source income from U.S. tax. The issues surrounding deductibility of expenses for purposes of determining the taxable income qualifying for foreign tax credit relief has been the source of numerous legislative changes and voluminous regulations. The effect of these rules requires taxpayers to address a complex web of rules designed to restrict foreign tax credits to what is defined as an appropriate amount of foreign source taxable income. Under the discussion draft, the foreign tax credit would primarily be relevant to subpart F income and withholding taxes on interest and royalties earned from foreign loans and licenses. Only one “foreign tax credit limitation” need be computed (rather than separate limitations for separate “baskets”), and only directly allocable expenses would reduce the limitation. Consideration should be given to imposing restrictions on the use of pre-effective date foreign tax credits from active business operations to reduce U.S. tax on passive income.

II. Deductible Expenses

The territorial system of taxation raises the question of whether restrictions should be placed on deductions of a domestic corporation attributable to its exempt foreign income. Rather than prescribe rules disallowing deductions allocable to income excluded from the U.S. tax base by the participation exemption, the discussion draft follows the position adopted in a number of countries which reduce the amount of the exemption, typically to 95%, as a reasonable proxy for expenses incurred in the domestic country that are attributable to exempt foreign income. It is important to note that the deductibility of expenses is a factor in retaining and expanding the employment related to those support functions in the United States. It also has a varying impact among taxpayers, since some businesses are more highly leveraged than others. The United Kingdom, interestingly, chose to allow a 100% exemption for active foreign income and does not place any restriction on deductions. Placing no restriction on deductions is consistent with the policy objective of encouraging the performance of corporate activities in the United Kingdom.³

The discussion draft would also expand our present-law limitation on the current deductibility of interest expense in a manner similar to rules applied to foreign companies investing in the United States through U.S subsidiaries. Current deductions for net interest expense would be subject to the greater of two limits: (1) net interest expense attributed to non-“excess” domestic indebtedness (computed by comparing the U.S. debt to asset ratio to the world-wide debt to asset

³ See e.g. Speech by the Chancellor of the Exchequer, Rt Hon George Osborne MP, at the CBI Annual Dinner, Grosvenor House Hotel, London (May 19, 2010) (stating: “Our aim is to create the most competitive corporate tax regime in the G20, while protecting manufacturing industries.... As well as lower rates and a simpler system, I want to reform the complex Controlled Foreign Companies rules that have driven businesses overseas. I want multinationals coming to the UK, not leaving. I am under no illusions. Achieving all this will be hard and it won’t happen overnight. But let us work together for the long term, because ultimately all of Britain’s businesses will be winners if we succeed”).

ratio); or (2) a specified percentage of adjusted taxable income as defined under section 163(j).⁴

The United Kingdom does not restrict the deduction of third party indebtedness incurred in a UK parent entity, irrespective of the level of non-UK operations conducted through foreign affiliates or foreign branches. Under Chairman Camp's discussion draft, a portion of third party net interest expense incurred by a U.S. parent company will not be currently deductible, to the extent the interest expense exceeds the prescribed thresholds. If deductions are not allowed in the United States, companies will consider increasing indebtedness outside the United States, which may increase their overall cost of borrowing.

III. Expansion of Subpart F Income

Under the heading of "prevention of base erosion," the discussion draft includes three alternatives for significantly expanding the existing subpart F rules. Since their first enactment in 1962,⁵ these rules have attempted to protect the U.S. tax base by identifying those types of income that were not related to active business operations and which could be easily relocated to lower taxed foreign affiliates.⁶

⁴ Unless otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

⁵ See Committee on Finance, 87th Cong., 2d Sess., Draft of Statutory Language with Accompanying Explanation of Amendments Proposed by the Secretary of the Treasury on May 10, 1962, to Sections 13, 15, 16 and 20 of H.R. 10650, III (Comm. Print 1962), reprinted in Revenue Act of 1962, Hearings before the Committee on Finance on H.R. 10650, 87th Cong., 2d Sess., (Part Eleven) 4415 (1962). See also S. Rep. No. 1881, 87th Cong., 2d Sess. (1962).

⁶ In the same spirit, section 954(h) was later enacted to provide for deferral of qualified banking or financing income of a CFC engaged in the active conduct of a banking business (the "active financing exception"). The discussion draft does not address the continued application of section 954(h). Continued application of the active financing exception should be considered as part of any participation exemption for income derived by a CFC in the active conduct of a trade or business.

Under Option A of the discussion draft's subpart F alternatives, income derived by a CFC from outside of its country of incorporation would be currently subject to tax in the United States if: (1) the income is from the use of U.S.-transferred or co-developed intangible property; (2) the income exceeds 150% of certain costs allocated to the income other than interest expense and taxes and indirect expenses; and (3) the income is taxed in a local jurisdiction at a foreign effective tax rate of 10% or less.⁷ Option B is an even broader expansion of subpart F requiring all income of a CFC to be currently taxed in the United States if the income is derived outside the CFC's country of incorporation and if it is subject to an effective rate of tax of less than 10%. Option C would tax currently CFC income to the extent attributable to intangible property and subject to a foreign effective tax rate of 13.5%.⁸ However, in a separate provision, a 40% deduction is allowed with respect to both foreign intangible income of the U.S. corporation itself, and any subpart F inclusions of CFC intangible property income that is foreign intangible income—and such income is limited to the sale of property or provision of services in foreign markets.

The proposed Options A and C would impact the ability of U.S. companies to use intellectual property in the course of active business operations conducted outside the United States and thereby weaken their competitiveness as against other similarly situated non-U.S. owned businesses operating in the same markets. In France, Germany, Japan and the United Kingdom, income attributable to sales and services performed by CFCs is not subject to bifurcation

⁷All of the excess intangible income would be subpart F income if the effective tax rate on the intangible income was less than 10% and none of the income would be treated as subpart F income if the effective tax rate exceeded 15%, with a sliding scale applicable to income subject to rates between 10 and 15%.

⁸This rate is determined assuming a 25% maximum tax rate, a deemed deduction of 40% and a high taxed safe harbor under section 954(b)(4) of 90% of the maximum tax rate imposed under the Code. These provisions create a high taxed exception to subpart F income where the income is subject to a 13.5% foreign effective income tax rate.

between intangible-related returns and non-intangible returns under present law. For example, where a parent company resident in any of these jurisdictions establishes a subsidiary in Ireland that utilizes intangible property to manufacture and sell products, the active income of the CFC is generally not subject to current taxation in the parent company's country of residence.⁹

If any of these options were enacted, it would represent the first time that the subpart F rules would look so fundamentally to foreign tax rates for purposes of defining when CFC earnings should be currently taxed in the United States. Historically, subpart F rules have focused generally on whether income was derived from third parties or in the active conduct of manufacturing, performance of services or active licensing of intangible property or active leasing of tangible property. Option A, in addition, has the novel feature of focusing on a CFC's rate of return on expenses. By triggering current taxation when the return exceeds 150%, the option provides an incentive to push deductible development and marketing costs into the CFC, which is inconsistent with the policy objective of the subpart F provisions. By taxing income attributable to intangibles, Options A and C also characterize as base erosion the use of one of the most important inputs to products and services in a number of industries. In effect, U.S. technology is exported in products and services delivered by U.S.-based multinational enterprises throughout the world. Companies use intellectual property to generate profits offshore because that is where they must operate to meet the needs of their global customers.

⁹ A number of jurisdictions require that a CFC meet the requirements of an active trade or business test in order to qualify for exception to current taxation under the relevant CFC rules. For example, in Japan, the CFC must meet the following tests: (i) active business requirements, (ii) substance requirements, (iii) local management and control, and (iv) conduct of a local business.

Under current law, a CFC must pay for the right to use intellectual property outside the United States if the intellectual property is owned by the U.S. parent corporation of the CFC. Treating income from active business operations as subpart F solely on the basis of intangible property that was acquired in an arm's length transaction is inconsistent with the arm's length standard for transfer pricing which is the cornerstone of international taxation for the members of the OECD. The subpart F options, therefore, may actually result in double U.S. taxation of intangible income. First, the intangible assets transferred to a CFC are taxable to a U.S. transferor. Secondly, income earned by the CFC from use of the intangible is subject to another U.S. tax as subpart F income.

The intangible income options also raise concerns related to the effective administration of our tax law. These options would require taxpayers to determine the amount of income of a CFC that is attributable to intangible property. This measurement of intangible income requires taxpayers to "unscramble the economic egg" by identifying the amount of revenue and expenses attributable to intangible property as compared to income of the CFC derived from a return on capital, services, manufacturing or marketing activities. Requiring segregation of the return from intellectual property will result in significant controversy during the examination process as taxpayers and the IRS attempt to subdivide the returns on transactions. Such a theoretical subdivision of income from a single transaction is considerably more complex than adjusting the transfer prices for actual transactions based on other, actual transactions among uncontrolled taxpayers.

Another departure from current law in the discussion draft is the treatment of subpart F income that is remitted back to the United States. Under present law, there is generally no residual U.S. tax imposed on the remittance of CFC earnings that have already been subject to U.S. tax as subpart F income.¹⁰ The discussion draft would first impose a U.S. corporate income tax of 25% on the subpart F income as it is earned by the CFC. Upon remittance, the dividend distribution would be included in the U.S. shareholder's income subject to a 95% dividends received deduction, thereby resulting in an additional level of U.S. tax of 1.25% on the same income. This would mean that 5% of the subpart F income is subject to double U.S. taxation. There does not appear to be a policy reason for imposing a higher rate of U.S. tax on remitted subpart F income earned by a CFC than would have been imposed if such income was generated in the United States. This incremental tax retains, albeit at a lower cost, the lockout of earnings by imposing an incremental charge on repatriation.

The current draft does not provide for the continuation of the CFC "look-through rules" that exclude from subpart F income certain payments of interest, rents and royalties between related CFCs. These payments represent an important source of funding of CFC operations. The rules operate in a manner that allows for active income in one affiliate to be replaced as active income in another affiliate to the extent of the deductible payment. Applied in the context of the draft's participation exemption, there would be no net incremental amount of earnings being exempted because the deductible payment must be allocated to active business income in order to be exempted. These payments should simply be viewed as allowing for the efficient use of capital

¹⁰ Additional U.S. tax may be incurred on the remittance of previously taxed income under subpart F to the extent of the appreciation in the dollar value of a CFC's functional currency at the time of remittance, as compared to the translation rate used to determine the original income inclusion. See section 986(c).

among CFCs, and I recommend that these rules be retained in any future tax regime relating to foreign corporate income.

IV. Transfer Pricing

The current U.S. system places great emphasis on transfer pricing rules under section 482 to ensure that taxpayers do not inappropriately shift income between domestic and foreign operations. Transfer pricing rules are certainly important in a territorial system, because transactions between a foreign subsidiary and its domestic parent will move taxable income into or out of the participation exemption. Some may argue that the territorial system places greater emphasis on transfer pricing because the income is exempt rather than deferred under current law. Given the importance of the reporting of taxable income on tax returns and financial statements related to profits deferred in CFCs, I would suggest that transfer pricing is of equal importance in both systems.

V. Branch Operations

The discussion draft treats foreign branches of domestic corporations like a CFC for all purposes of the Code. This results in a 95% exemption of active business income earned by the foreign branch to its domestic parent. The treatment of foreign branches in territorial tax systems varies according to the system. For example, France, the United Kingdom and Germany will exempt active business income derived from foreign branches. Japan, on the other hand, applies its corporate income tax to all branch earnings, but does not impose its enterprise tax on such

earnings. The importance of branch operations is relevant because many U.S. corporations will conduct foreign operations themselves or through directly-owned flow-through entities.

The discussion draft proposal raises a number of technical issues related to the treatment of branches like subsidiaries for purposes of the Code. For example, will payments between branches be treated like interest and royalties and create subpart F income? Will the conversion from branch status to CFC status be excepted from tax imposed by section 367, dual consolidated loss recapture, branch loss recapture, or overall foreign loss recapture? Will advances between branches be treated as “springing” loans resulting in taxable income? Presumably, branch remittances will be subject to a 1.25% residual tax on remittance, which requires carefully monitoring branch remittances. Finally, the exemption of branch income will presumably require that transfer pricing principles be adopted in order to determine the amount of income attributable to the branch that qualifies for exemption.¹¹

VI. Corporate Tax Rate

While the corporate tax rate is not the primary focus of this hearing, the discussion draft takes the important step of reducing the corporate income tax rate to 25%. A 25% corporate income tax rate would bring U.S. corporate income tax rates in line with the average of OECD countries. Corporate tax rates in other countries have been reduced over the last decade. In 2000, the average corporate income tax rate for OECD countries was 32.6%; by 2010 that average rate had been reduced to 25.4%. During this period, corporate tax rates were reduced in 31 OECD

¹¹ Some companies are required to operate overseas in branch form for regulatory reasons. The proposal will require the application of transfer pricing principles to determine the correct amount of taxable income attributed to branch operations.

countries, including France, Germany, and the United Kingdom.¹² A move to reduce the corporate income tax rate will allow U.S. corporations to be subject to a domestic tax rate that is consistent with that applied in other countries competing for the multinational corporate tax base.

VII. Transition rules

The implementation of any territorial system must address the taxation of prior year's earnings retained in CFCs. The treatment of these earnings will have significant financial statement impact and a mandatory inclusion of 15% of the pre-effective date deferred earnings in taxable income will likely result in additional tax charges reflected in financial statements. Further, a mandatory inclusion of 15% of prior year's earnings will result in a tax cost with no current cash being generated to pay the tax. If earnings have been reinvested in expanding business operations outside the United States, then a company must find other sources of cash in order to pay U.S. tax on previously deferred earnings that are required to be included in income. Japan and the United Kingdom generally do not impose a tax on the remittance of pre-effective date earnings. This decision is consistent with the stated policy objective of promoting the remittance of earnings to grow operations conducted in the home country. The tax imposed on pre-effective date earnings will reduce the funds available for such purposes. This issue will undoubtedly be part of the broader discussion of the fiscal objectives associated with implementing a territorial system in the United States.

Thank you for allowing me to participate in today's hearing.

¹² OECD *Challenges in Designing Competitive Tax Systems*, June 30, 2011

Chairman TIBERI. Thank you, sir.
Mr. Noren, you are recognized for five minutes.

**STATEMENT OF DAVID G. NOREN, PARTNER, McDERMOTT,
WILL & EMERY, WASHINGTON, D.C.**

Mr. NOREN. Chairman Tiberi, Ranking Member Neal, and distinguished Members of the Subcommittee, thank you for the opportunity to testify today regarding the Ways and Means Committee discussion draft on international tax reform. My name is David Noren, and I am a partner at McDermott, Will & Emery LLP, where I focus on international tax planning. The views I am expressing here today are my own, and do not necessarily represent the views of McDermott or any of its clients.

I would like to start by commending the committee leadership and staff for producing such a detailed and thoughtful proposal in an important area of the tax law. My testimony today focuses on the discussion draft's three alternative subpart F proposals addressing concerns about the potential erosion of the U.S. tax base through the shifting of income to low-tax jurisdictions.

My view is that adopting a territorial system is unlikely to place significant additional pressure on the transfer pricing and subpart F regimes, and that questions relating to the proper scope of the transfer pricing and subpart F rules are largely independent of whether a deferral or a dividend exemption approach is pursued. Thus, the adoption of territoriality, in and of itself, does not create any new imperative to tighten these rules.

The discussion draft's proposed reduction of the top corporate income tax rate to 25 percent actually may have more bearing on the proper approach to transfer pricing and subpart F than does dividend exemption itself. A case could be made for taking a more restrictive approach to transfer pricing and subpart F as the corporate rate is reduced to a level more in line with the rates applicable in other OECD countries, although the strength of such a case would, of course, depend on the nature and scope of the restrictions in question.

The discussion draft's three alternative subpart F proposals reflect three quite different ways of further limiting the ability of taxpayers to shift income to low-tax jurisdictions and, ultimately, three different theories of what behavior is thought to be objectionable.

Is it the earning of profits from IP by a foreign subsidiary? If so, does it matter whether the IP was developed entirely within the U.S., entirely outside the U.S., or partly within and partly outside the U.S.?

Are low foreign tax rates a concern in and of themselves, or only when paired with other factors, such as IP return, or a lack of certain kinds of business activities in the relevant jurisdictions?

To what extent does it matter whether a foreign subsidiary is earning income from selling into its home country market, foreign markets in general, or the U.S. market?

How are concerns about potential income-shifting to be balanced against other economic policy concerns such as U.S. employment and innovation leadership?

Each of the three alternative proposals provides different answers to these questions. Option A, which is substantially similar to the Obama Administration's excess returns proposal, reflects a concern about U.S.-developed IP being transferred to a foreign sub-

sidiary. Option A would tax currently a foreign subsidiary's excess income that is subject to a low foreign tax rate if the income has any connection at all to IP transferred from a related U.S. person. A narrow exception is provided for cases in which the CFC sells into its home country market.

The most fundamental concern about the excess returns proposal is that, by gearing taxation to where IP originates, it might encourage the migration of R&D activity from the U.S. This option thus entails significant tension between the goal of restricting income shifting and other economic policy goals.

Option B provides that a foreign subsidiary's income that is subject to a low foreign effective tax rate is subpart F income, subject to a narrow home country exception. Under option B, unless a foreign subsidiary is essentially selling into its own home country market, an effective tax rate of 10 percent or less will lead to the treatment of the subsidiary's income as subpart F income, regardless of the other facts and circumstances surrounding the subsidiary's earning of the income.

Thus, even if the subsidiary makes very significant contributions to the earning of the income, and no U.S. affiliate provides IP or makes any other contribution, subpart F would apply.

Both option A and option B might be improved, in my view, by providing a somewhat broader home country exception that would accommodate structures with a significant business presence in the country of organization, even if the foreign subsidiary is selling into other markets. Low foreign tax rates alone, or low foreign tax rates in the presence of some relevant IP originating in the United States, should not suffice to trigger subpart F.

Option C is a very inventive proposal that essentially boils down to current basis taxation of income attributable to IP, with a preferential rate being applied for IP income relating to serving foreign markets, and a normal rate being applied for IP income relating to serving the U.S. market. A key issue under option C will be how to attribute income to IP, which could create a need for valuation and transfer pricing type analyses of a kind not required under present law.

In sum, I think all three options have some merit, and might usefully be developed further, but all three raise significant issues. Under any approach to tightening the subpart F rules, I would urge that efforts be made to accommodate structures with substantial functionality in the relevant locations in order to avoid interfering with common business models.

I thank you again for the opportunity to present my views on this important subject, and I again commend committee leadership and staff for advancing the debate in this area. I would be pleased to answer any questions you may have at this time or in the future.

[The statement of Mr. Noren follows:]

**Testimony Before the
Subcommittee on Select Revenue Measures
Committee on Ways and Means
United States House of Representatives**

David G. Noren

November 17, 2011

Introduction

Chairman Tiberi, Ranking Member Neal, and distinguished Members of the Subcommittee, thank you for the opportunity to testify today regarding the recently released Ways and Means Committee discussion draft on international tax reform (the “Discussion Draft”).

My name is David Noren, and I am a partner at McDermott Will & Emery LLP (“McDermott”), where I provide international tax advice to multinational companies across a range of different industries. I previously served as legislation counsel on the staff of the Joint Committee on Taxation (“JCT”), where I also handled international tax issues. The views I am expressing here today are my own and do not necessarily represent the views of McDermott or any of its clients.

General Observations on the Discussion Draft

I would like to start by commending the Committee leadership and staff for producing such a detailed and thoughtful proposal in a difficult and important area of the tax law. For several years now, various official reports and proposals have recommended the adoption of a territorial dividend exemption system,¹ but the debate could proceed only so far without detailed legislative language. The Discussion Draft provides this detailed language and thereby makes a major

¹ See, e.g., Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05, at 186-97 (Jan. 27, 2005) (proposing a territorial system); President’s Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System*, at 132-35 and 239-44 (Nov. 2005) (proposing a territorial system); U.S. Department of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, Dec. 20, 2007, at 54-63 (discussing territorial alternatives in generally favorable terms); President’s Economic Recovery Advisory Board, *The Report on Tax Reform Options: Simplification, Compliance, and Corporate Taxation*, at 89-91 (Aug. 2010) (discussing a territorial system in generally favorable terms compared to other alternatives presented); National Commission on Fiscal Responsibility and Reform, *The Moment of Truth*, at 32-33 (Dec. 2010) (recommending the adoption of a territorial system); “Gang of Six” Senators, *A Bipartisan Plan to Reduce Our Nation’s Deficits*, at 4, available at 2011 TNT 139-28 (Jul. 2011) (recommending the adoption of a territorial system). While on the JCT staff, I worked on the JCT report cited above.

contribution to the territorial debate. While the language was only recently released, and thus is only beginning to be analyzed by the tax community (myself included), the language already has helped focus the community on some important territorial design issues that have previously received little attention in more general discussions of the territorial concept.

We will all be able to find aspects of the Discussion Draft that we would approach differently, and indeed the Discussion Draft itself does not purport to resolve conclusively every last issue that it raises, but as we set about the work of trying to improve on the Discussion Draft, we should do it with considerable appreciation for the Members and staff who took the important step of putting this proposal together and opening it up for comments so early in the tax reform process.

I recently published an article in which I considered several of the key technical issues raised by adopting a territorial tax system.² In my article I emphasize that the word “territorial” can be used to describe quite different approaches to taxing U.S.-based multinationals, and that the devil will be in the technical details of how a territorial system is implemented.

The one essential feature of a territorial dividend exemption system is that dividends from foreign subsidiaries are substantially exempt from U.S. Federal income taxation. This dividend exemption removes certain distortions of corporate financing and cash management decisions that arise under the current system of repatriation-based taxation of foreign earnings (a phenomenon sometimes referred to as the “lock-out effect”). This is a problem well worth solving, and the territorial path is one that has been taken by most of our major trade and investment partners.

Beyond removing these distortions of the current system, the net effect of adopting a territorial system will depend critically on the resolution of key design issues raised by exempting foreign subsidiary dividends. These issues include how to treat domestic expenses that might be viewed as allocable and apportionable to exempt foreign income, whether to provide full dividend exemption or instead exemption with a “haircut,” the nature and extent of the continued role of the foreign tax credit, the scope of the “subpart F” controlled foreign corporation (“CFC”) regime, and the mechanism for transitioning from the current system to the new system, to name just a few. Depending on how issues like these are resolved, a territorial system could increase, decrease, or have a roughly neutral effect on the overall U.S. tax burden on U.S.-based multinationals.

The Discussion Draft seeks to implement a territorial system on a revenue-neutral basis, having first assumed that the top corporate income tax rate will be reduced to 25 percent as part of the broader tax reform process. In pursuit of this goal, the Discussion Draft includes several provisions designed to protect the U.S. fisc. My testimony today focuses on one set of these provisions, specifically the Discussion Draft’s three alternative subpart F proposals addressing

² David G. Noren, “Designing a Territorial Tax System for the United States,” 40 Tax Mgmt. Int’l J. (BNA) 643 (Nov. 11, 2011). The Discussion Draft was released after the article had gone to press, but prior to the article’s publication date.

concerns about the potential erosion of the U.S. tax base through the shifting of income to low-tax jurisdictions.

The Discussion Draft's "Base Erosion" Provisions

Does the adoption of a territorial system require the introduction of further subpart F or transfer pricing restrictions?

A threshold question is whether adopting a territorial system would place significant additional pressure on the transfer pricing and subpart F rules, thus requiring either or both sets of rules to be made more restrictive. Some would argue that, by converting present law's deferral into permanent exemption or near-exemption, incentives for income shifting may increase significantly, and thus territoriality should not be pursued without the introduction of new measures to tighten the transfer pricing and/or the subpart F rules, which together serve to limit income shifting.

My view, as discussed in the aforementioned article, is that adopting a territorial tax system is unlikely to place significant additional pressure on the transfer pricing and subpart F regimes. Taxpayers already have strong incentives under the deferral system and applicable financial accounting principles to take the most advantageous transfer pricing and subpart F positions that they can support at an appropriate level of confidence, and the transfer pricing and subpart F rules, for all of their flaws, do impose real limits on income shifting. Converting indefinite deferral into 95-percent exemption should not dramatically alter the transfer pricing practices of most large multinationals. Some multinational companies may face strong domestic liquidity constraints and lack foreign growth opportunities, in which case the elimination of the high-rate repatriation tax might represent a more meaningful change in income-shifting incentives, but these situations should be relatively uncommon.

For these reasons, I think that questions relating to the proper scope of the transfer pricing and subpart F rules are largely independent of whether a deferral or a dividend exemption approach is pursued, and that the adoption of territoriality in and of itself does not create any new imperative to tighten these rules.

The Discussion Draft's proposed reduction of the top corporate income tax rate to 25 percent actually may have more bearing on the proper approach to transfer pricing and subpart F issues than does dividend exemption itself. Specifically, a case could be made for taking a more restrictive approach to transfer pricing and subpart F issues as the corporate rate is reduced to a level more in line with the rates applicable in other OECD countries, although the strength of such a case would of course depend on the nature and scope of the restrictions in question. In the absence of a major rate reduction, making the transfer pricing or subpart F rules more restrictive could produce effective tax rates for U.S.-based multinationals that would be excessively high by international standards.

If further subpart F restrictions are in order, what exactly is the targeted behavior?

The Discussion Draft's three alternative subpart F proposals targeting U.S. base erosion reflect three quite different ways of further limiting the ability of taxpayers to shift income to low-tax

jurisdictions, and ultimately three different theories of what behavior is thought to be objectionable.

Is it the earning of profits from intangible property (“IP”) by a CFC? If so, does it matter whether the IP was developed entirely within the United States, entirely outside the United States, or partly within and partly outside the United States? Are low foreign effective tax rates a concern in and of themselves, or only when paired with other factors, such as IP return or a lack of certain kinds of business activities in the relevant jurisdictions? To what extent does it matter whether a CFC is earning income from servicing its home-country market, foreign markets in general, or the U.S. market? How are concerns about potential income shifting to be balanced against other economic policy concerns, such as U.S. employment and innovation leadership? Each of the three alternative proposals provides different answers to these questions.

Option A (“excess returns” proposal)

Option A, which is substantially similar to the Obama administration’s “excess returns” proposal, reflects a concern about U.S.-developed IP being transferred to a CFC. Under Option A, if a U.S. person transfers IP to a related CFC, then the CFC’s “excess” income from transactions benefiting from the transferred IP and subject to a “low” foreign effective tax rate would be subpart F income. “Excess” income is generally defined as any amount of gross income above 150 percent of directly allocable and apportionable costs (not including interest or taxes). A foreign effective tax rate of 10 percent or less is “low,” with sliding-scale application of the rule for effective tax rates between 10 percent and 15 percent. A relevant IP “transfer” may have occurred at any time, even prior to the provision’s effective date, and may have occurred by way of cost-sharing or co-development arrangements typically not thought to entail a transfer of IP. A narrow home-country exception is provided for income earned by a CFC from sales into its own home-country market or the performance of services there.

Although the proposal speaks in terms of IP being transferred from the United States, the proposal as currently drafted could taint an entire income flow that is attributable in large part to foreign-developed IP, based on the presence of relatively minor U.S. IP relating to the relevant product or service. In other words, the proposal does not narrowly address U.S.-developed IP, but rather creates a “cliff effect” based on the presence of any relevant U.S.-developed IP at all.³

Whether or not this cliff effect is addressed, the most fundamental concern about the excess returns proposal is that it might encourage the migration of R&D activity from the United States. If all IP relating to a product is developed abroad, then the proposal does not apply to the income generated by the product. If new restrictions on income shifting are thought to be necessary, it may make sense to develop an approach that is more neutral with respect to the locations where R&D work is performed. The United States does not have a monopoly on talent, and we should keep this fact in mind as we contemplate tax policies that would impose new burdens on the performance of economically critical activities here.

³ The proposal is not technically geared to where IP is developed, but rather to whether it is transferred by a related U.S. person. In referring to the location of IP development, I have in mind the practical effects of the proposal, as opposed to the mechanism by which those effects are produced.

Another concern about the proposal relates to the scope of the costs included in the base that is marked up under the 150-percent rule in determining excess income. It appears that a CFC's costs of goods sold ("COGS") might *not* be marked up under this rule, whereas other costs would. This would result in harsher treatment of a higher-COGS CFC relative to a lower-COGS CFC, even if both CFCs earn the same net income from products involving U.S.-developed IP, because less of the former CFC's total costs would be uplifted for purposes of determining any excess income. This seems like an arbitrary result.

Similarly, the treatment of royalties paid by a CFC for purposes of the excess income determination needs further clarification. Royalties may be an element of COGS in many situations and thus may be affected by the uncertainty surrounding the COGS issue. The proposal does specify that R&D costs are marked up under the 150-percent rule, which would seem to embrace situations in which a CFC bears R&D costs in a cost-sharing, co-development, or R&D services arrangement, but in many cases it will not be clear that royalties paid by a CFC for the use of IP in producing a product or performing a service will count as R&D costs for this purpose. If a CFC pays a royalty for the use of IP relating to the product or service that the CFC sells, it would seem appropriate to include these royalties as relevant costs in determining the extent of any excess return.

In sum, Option A could be improved in important respects by addressing various technical points, but it seems unavoidable that this option entails significant tension between the goal of restricting income shifting on the one hand and pursuing other economic policy goals involving the preservation and creation of U.S. R&D jobs and U.S. leadership in innovation on the other hand. The proposal may deserve further consideration if further restrictions on income shifting are thought to be necessary, but there are clearly some major issues to be surmounted.

Option B ("low tax" proposal)

Option B provides that a CFC's gross income that is subject to a foreign effective tax rate of 10 percent or less is subpart F income, subject to a narrow home-country exception. The home-country exception applies only if: (1) the income arises from the conduct of a trade or business in the CFC's country of organization; (2) the CFC maintains an office or fixed place of business in such country; and (3) the income is derived in connection with property sold for use in such country or services provided with respect to persons or property located in such country. Due to the last condition of this three-part conjunctive test, unless a CFC is essentially selling into its own home-country market, an effective tax rate of 10 percent or less will lead to the treatment of the CFC's income as subpart F income, regardless of the other facts and circumstances surrounding the CFC's earning of the income. The effective tax rate analysis is to be done on a country-by-country basis for each country in which the CFC has a trade or business, although the mechanics of how this separate-country analysis should apply are not specified in great detail. Option B does not rely on any attribution of income flows to any particular kind of IP (or to IP at all).

Option B might be improved by providing a somewhat broader home-country exception that would accommodate structures with some significant substance in the country of organization, even if the CFC is selling into other markets. For example, the rules could require that the CFC's employees make something akin to a "substantial contribution" to the relevant revenue-

generating activities.⁴ Because Option B applies to a broader category of taxpayers and activities than do the foreign base company sales income rules to which the existing substantial contribution test relates, the substantial contribution concept would need to be expanded somewhat to serve this purpose (i.e., it would need to embrace activities beyond those relating closely to a manufacturing supply chain, such as marketing, sales, and general managerial activities, as well as activities relating to services businesses).⁵ A balance would need to be struck between providing sufficiently robust requirements to prevent the avoidance of the low-tax rule through the use of entities with minimal functionality (e.g., the performance of purely clerical or ministerial functions), while not requiring so much foreign activity as to encourage substantial migration of key functions from the United States to foreign locations. As noted previously, the goal of preventing income shifting is often in some tension with other economic policy goals, so caution is warranted.

Potential points of technical clarification under Option B might include clarifying that income inclusions are pro-rated in situations in which a CFC has both “good” and “bad” streams of income and clarifying the operation of the country-by-country determinations in situations involving CFC trades or businesses in multiple countries.

Option C (“carrot and stick” IP taxation proposal)

Option C provides that all CFC income attributable to IP related to property or services sold or provided by the CFC is subpart F income, but a U.S. shareholder is entitled to deduct 40 percent of income attributable to IP relating to property sold into foreign markets or services provided with respect to persons or property outside the United States (whether such income takes the form of a subpart F inclusion or a direct receipt, such as a royalty). Thus, IP-related income is tentatively taxed on a current basis at the new generally applicable top corporate rate of 25 percent, and then the portion of such income relating to serving foreign markets, as opposed to U.S. markets, is 40-percent deductible, leading to a current-basis U.S. effective tax rate of 15 percent [$.6 * .25$] on the latter portion of the income (leaving aside the additional 1.25 percent tax to come at the time of distribution of subpart F earnings, due to the Discussion Draft’s elimination of the “previously taxed earnings” rules).

The general subpart F high-tax exception would apply to this new category of subpart F income, using 13.5 percent [$.9 * .6 * .25$] as the relevant threshold, although this threshold presumably was not intended to apply for purposes of all “foreign base company intangible income,” but rather to just that portion of such income constituting “foreign intangible income” from serving foreign markets.

IP is broadly defined for these purposes. Unlike the excess returns proposal, this proposal seeks to limit its application to the income actually attributable to IP, but the proposal does not specify how this attribution is to be done.

⁴ See Treas. Reg. sec. 1.954-3(a)(4)(iv) (establishing a “substantial contribution” category of manufacturing for purposes of the manufacturing exception under the subpart F foreign base company sales income rules).

⁵ A similar exception could also be added to Option A.

Option C is a very inventive proposal that essentially boils down to current-basis taxation of IP profits, with a preferential rate being applied for IP profits relating to serving foreign markets, and a normal rate being applied for IP profits relating to serving the U.S. market (sometimes pejoratively referred to as “round-tripping” transactions). The preferential rate represents a variation on “IP box” approaches implemented or considered by other countries and could serve to mitigate certain additional tax burdens that the adoption of a territorial system might otherwise impose on companies that earn a large portion of their IP return in the form of currently taxable income of a U.S. company, like royalties (due to the loss of the foreign tax credit averaging that reduces the U.S. tax burden on these royalties under the current deferral system). At the same time, the imposition of current-basis taxation seeks to further restrict income shifting.

Option C is complex, and perhaps more than any other aspect of the Discussion Draft will require further study on the part of the tax community before a fully informed judgment can be made. A key issue will be how to attribute income to IP, which could create a need for valuation and transfer-pricing-type analyses of a kind not required under present law.

A broader concern for taxpayers might be that Option C to some extent resembles a repeal of deferral, with some of the income being subject to lower rates. Although such an approach could in concept be attractive to taxpayers if a sufficiently low rate could be implemented and then maintained, historically there has been concern that rates might be too easily amended under such a system, making it difficult for taxpayers to be assured of a reasonably stable effective tax rate over time.

A potential variation on this concept might be simply to administer the Discussion Draft’s dividend “haircut” on a current basis, rather than allowing it to be deferred. This would ensure current-basis taxation of all of a CFC’s income at a low rate (1.25 percent, assuming a 5-percent haircut and a 25-percent general rate), with no offset by foreign tax credits under the Discussion Draft’s approach to the foreign tax credit rules, and with present-law subpart F and transfer pricing rules continuing to apply. This variation would serve to reduce income-shifting incentives to some extent, without getting into the definitional and other complexities raised by creating entirely new categories of subpart F income. This variation also might be seen as a slippery step toward more general and higher-rate current-basis taxation of CFC income, but it would be considerably more limited and potentially less complex than some of the more ambitious alternatives.

The Discussion Draft’s base erosion alternatives in the broader subpart F context

Another set of issues relating to the Discussion Draft’s base erosion alternatives involves how these proposals fit into the existing subpart F framework. The Discussion Draft does not eliminate any of the existing categories of subpart F income, but rather would apply the new restrictions concurrently with the existing ones.⁶ If the existing subpart F rules are indeed thought to be inadequate in controlling income shifting, and a new approach can be found that

⁶ The Discussion Draft would repeal the deemed-repatriation rules of section 956, but this is essentially a conforming change in adopting a territorial system.

more appropriately balances the various competing policy considerations, then perhaps that new approach should replace the existing subpart F categories rather than sitting alongside them. The adoption of a territorial system thus could serve as an opportunity for a broader reform and simplification of the subpart F rules, instead of just making subpart F more restrictive and complex.

The Discussion Draft is also silent on the subject of the CFC look-through rule of Code section 954(c)(6) and the subpart F active financing and insurance exceptions. These provisions or something like them would remain important under a territorial system. It presumably should not be inferred from the Discussion Draft's silence regarding these temporary (and soon-to-expire) provisions that the provisions are on the chopping block in connection with an international tax reform effort.

A final subpart F issue that deserves notice is the Discussion Draft's elimination of the rules providing for the tax-free distribution of previously taxed earnings under Code section 959 and the related basis adjustment rules of Code section 961. While this repeal may accomplish a simplification of the law and raise some revenue, some will question the basis for taxing subpart F income more heavily than purely domestic income. In addition, if this approach is pursued, there will be a particular need to coordinate this approach with efforts on the individual and general business taxation fronts to ensure that U.S. shareholders who are not entitled to territorial dividend exemption do not suffer a second application of full-rate U.S. tax on their subpart F income when earnings are distributed.

Conclusion

I thank you again for the opportunity to present my views on this important subject, and I again commend Committee leadership and staff for advancing the debate in this area. While I have offered much constructive criticism in this testimony, my predominant reaction is one of appreciation and respect for the impressive work that the Discussion Draft represents. I would be pleased to answer any questions you may have at this time or in the future.

Chairman TIBERI. Thank you.
Mr. Oosterhuis, you are recognized for five minutes.

STATEMENT OF PAUL W. OOSTERHUIS, PARTNER, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP & AFFILIATES, WASHINGTON, D.C.

Mr. OOSTERHUIS. I too appreciate the opportunity to speak to you today here on this important bill. I think when international tax reform is finally enacted—and hopefully that is sooner, rather than later—we will see the introduction of this bill as one of the key milestones to move in that direction. It is a very important event.

By eliminating our current system of taxing foreign income but with deferral, and replacing it with a mixture of exempting a large portion of foreign business income, and beginning the discussion of how much of that income should be currently taxed, it seems to me the bill provides a framework for resolving the important issues in international tax reform that members of both parties can engage in, and that, indeed, those of us who have thought about a territorial system for a long time can embrace.

Ending the lock-out effect, as Mr. Neal mentioned in his remarks, and limiting the role of the foreign tax credit, which is a terribly complicated and flawed mechanism as it has evolved in our law over the last 30 years, as some of the witnesses have mentioned, achieves very important goals in international tax reform.

Mr. Noren spoke at some length in his five minutes on the various subpart F options that are expanding the potential business income that is subject to current taxation. I would like to focus in my five minutes on the expense disallowance issues that are raised by the bill, and comment on their treatment in the bill.

Today, as other witnesses have mentioned, because we have a system that, when it taxes foreign earnings, it taxes them worldwide with a foreign tax credit, there is a lot of pressure on the issue of what is foreign income against which you can take the credit, and what expenses are allocated to that income. We have a very broad definition of foreign-source income that is eligible for the credit and of expenses allocable to that income.

When you move to a territorial system, as this bill does, the definition of income that is eligible for exemption is much more narrow, as it should be. Income like royalties that U.S. companies are earning from abroad, interest that U.S. companies are earning from abroad, are not eligible for the exemption. That is appropriate, because they are deducted in a foreign jurisdiction, so if they were eligible for an exemption they wouldn't be taxed anywhere in the world.

But they are foreign-source income under today's rules. So, once you dramatically change, as this bill does, the amount of income that is treated as foreign and therefore eligible for the exemption, from what we have today, you do need to rethink what expenses are treated as being attributable to that income, and therefore, under today's rules, they are allocated to foreign-source income in determining how much credits you get.

In an exemption system any allocated expenses would be disallowed. And disallowing major expenses for U.S. multinationals is obviously a very important issue, because it can affect them competitively, compared to foreign companies, as well as can result in

tax policy that just doesn't make sense, in terms of the matching of income and expense.

There are three expenses that are normally put in this category, and are allocated under present law: R&D expenses, G&A expenses, and interest expense. Those are the three kinds of indirect expenses that are at issue.

The bill rightly does not disallow any deduction for R&D expenses. And that is because, as I said before, we are now taxing royalty income, and not allowing a foreign tax credit, by and large, against it. And in that system, it is entirely appropriate to allow a full deduction for R&D expense, because it is the royalties that are the income offset for the expense, and that is being fully taxed. So, just as a tax accounting matter, that makes sense.

The second area of expense, which is G&A, the bill does not disallow a deduction for that expense, either. And I think that is entirely appropriate because, to the extent U.S. multinationals can charge out that expense to their foreign affiliates, it should be deductible. And to the extent it can't be charged out to foreign countries, then it is appropriately, in my mind, attributed to the U.S. income that is taxed, and not attributed to foreign income. Otherwise, the expense would not be deductible anywhere in the world.

Finally, with respect to interest expense, the bill does propose a thin capitalization mechanism that, in some circumstances, could disallow interest expense. In my own view, that is an appropriate approach because it says if a U.S. company has a very large amount of interest expense it should think about whether some of that expense shouldn't be pushed down to its foreign affiliates, and not just deducted in the United States.

I think the bill needs some refinement in that respect, but it is an important movement in the right direction, and I applaud the chairman for introducing it.

[The prepared statement of Mr. Oosterhuis follows:]

**Statement of Paul W. Oosterhuis, Partner, Skadden, Arps, Slate, Meagher & Flom
LLP**

**Testimony Before the Subcommittee on Select Revenue Measures of the House
Committee on Ways and Means**

November 17, 2011

It is my pleasure to appear before you to discuss the international tax reform discussion draft (the “Discussion Draft”) released on October 26 by the Committee on Ways and Means. I am appearing on my own behalf, and not on behalf of any client or organization. As such, the views I express here today are solely my own.

I. Introduction

Reforming the international tax system in a balanced and sustainable way is an important goal. The key features of the current system—taxation of domestic corporations’ worldwide income subject to a foreign tax credit and the deferral of taxation on certain categories of income of foreign subsidiaries—represent a legislative compromise forged in 1962, when U.S. companies were far more dominant in the global economy than they are today. Since then, changes in U.S. and foreign tax law, as well as in the global economic environment, have given rise to stresses and challenges that threaten to undermine that regime.

Two fundamental aspects of the current regime are unsustainable over the long run. First, in a world where most foreign countries have substantially reduced their corporate tax rates, the ability of U.S. companies to defer U.S. taxation of certain foreign income has encouraged those companies to leave their lower-taxed foreign earnings offshore, often indefinitely. This “lock-out” effect, which has trapped over \$1 trillion of

U.S. corporate earnings offshore, breeds economic inefficiency and discourages re-investment of those funds in the United States. It is a ticking time bomb for U.S. multinationals. Second, with respect to the few major countries (principally, Japan) with rates higher than U.S. rates, U.S. companies' ability to "cross-credit" those high taxes with foreign-source interest and royalties arguably circumvents intended limitations on the creditability of foreign taxes by reducing U.S. tax on items of income that are properly taxable in the U.S. and not in any foreign jurisdiction.

With the Discussion Draft, the Committee has offered a bold proposal that refocuses and advances the international tax reform debate in important ways. In commenting on the Discussion Draft, I will address both the policy goals that I believe should be advanced and specific issues that arise in implementing legislation to further those goals. There are four goals in particular that I believe international tax reform legislation should advance:

1. The system should be broadly consistent with that of other foreign countries to maintain the competitiveness of U.S. multinationals.
2. It should eliminate disincentives to repatriating foreign earnings.
3. It should minimize circumstances where taxpayers are indifferent to paying foreign tax; the U.S. should encourage, not discourage, the reduction of foreign taxes.
4. It should avoid increasing incentives to shift jobs, functions and income attributable to U.S. activities abroad.

The Discussion Draft goes a long way toward furthering these goals. The broad exemption for 95% of foreign-source dividends from CFCs is consistent with the practice of foreign countries. The lock-out of current and prior earnings would be eliminated by a combination of exemption and current taxation. To the extent of the exemption, taxpayers would have every incentive to reduce foreign tax; any broadening of subpart F should not undo that incentive (e.g., foreign related-party look-through rules should be maintained). The Discussion Draft's alternatives for expanding subpart F to minimize shifting of income and functions are a good start in thinking about a very difficult problem that involves the balancing of the various goals I have described. Hopefully other alternatives will emerge for consideration, as well.

By offering the Discussion Draft in the form of legislative language, the Committee has provided a foundation for beginning to think about issues in implementing this kind of legislation. Based on that language, I will offer my initial thoughts on the major provisions of the Discussion Draft.

II. Participation Exemption

The Discussion Draft's 95% dividends-received deduction ("DRD") for foreign-source dividends from CFCs, which is equivalent to a 95% exemption for such dividends, is the cornerstone of the territorial system proposed by the Discussion Draft and is consistent with international practice. With regard to the DRD, I would like to focus in particular on the rationale for taxing 5% of an otherwise eligible dividend. As a policy matter, I have no objection to this minor toll charge if its purpose is to generate revenue needed to implement the overall goals of the Discussion Draft. I do not believe that an effective 1.25% tax (assuming a 25% corporate income tax rate), or even an effective

1.75% tax (assuming today's 35% rate), on foreign-source dividends is significant enough to discourage companies from repatriating foreign earnings in a manner that would perpetuate the lock-out effect of current law. I would like, however, to explore and challenge the rationale offered for this toll charge by the Technical Explanation of the Discussion Draft, namely that the toll charge is intended as a substitute for disallowance of deductions for expenses incurred to generate exempt foreign income. As a tax policy matter, I do not believe any deduction disallowance beyond a thin capitalization-type rule that is included in the Discussion Draft to be appropriate in any case.

I start with the premise that in a properly designed territorial system, every expense that is currently in the nature of a deductible expense should be currently deductible. The relevant question for determining current deductibility of expenses in a territorial system is which jurisdiction should permit the deduction for a particular expense. In addressing this question, tax policy should be guided by the fundamental matching principle that an expense should be deductible against the tax base that will include revenue arising from that expense. Consider in turn the application of this principle to the three major categories of indirect expenses: interest expense, general and administrative ("G&A") expense, and research and development ("R&D") expense.

Full deductibility of interest expense is a crucial issue for many companies, as interest is often the largest indirect expense a company incurs. In the context of both a territorial system and a worldwide system with deferral, concerns have been expressed that borrowing by a U.S. multinational may finance investments that produce income not subject to current U.S. tax. This concern underlies foreign countries' interest deduction limitations and appears to motivate the Obama Administration's proposal to defer interest

deductions allocable to deferred foreign income. Indeed, in some circumstances, it may be more appropriate for a portion of domestic interest expense to be deducted in a country where a CFC earns income and pays tax than for that interest expense to reduce U.S. taxable income. As I will discuss later in this testimony, to effect this outcome where local borrowing by the CFC may not be efficient or feasible, any interest deduction disallowance or deferral provision should allow a U.S. parent with third-party debt to lend to its CFCs with the same consequences as if the CFC had borrowed directly from the third party with a parent guarantee. With a well-designed mechanism that acknowledges a CFC's interest expense deductions in its home country, U.S. multinationals can arrange their global capital structure so that no domestic interest expense deductions actually need to be disallowed.¹ The Discussion Draft's thin capitalization proposal provides a framework for such a mechanism. Thus, there is no need to reduce the DRD to 95% as an alternative to interest expense disallowance.

Both a deferral and a territorial system based on sound principles of tax policy also should permit the domestic parent of a multinational company to fully deduct G&A expenses somewhere in the world. Under the arm's length standard as applied both in the U.S. and under OECD transfer pricing guidelines, a domestic corporation may only require its CFCs to reimburse expenses that provide a benefit to the CFC that the CFC would pay for were it an unrelated party. Thus, for example, a domestic corporation generally is not permitted to charge its CFCs for a portion of the salary of the domestic corporation's CEO since any benefits of the CEO's activities to the CFCs likely would be

¹ For years prior to 2021, the Obama Administration's interest deferral proposal ignores these considerations by allocating interest based on the present-law "water's edge" mechanism that does not take into account debt incurred by CFCs. This approach raises substantial revenue but makes little tax policy sense in a world where interest is a generally deductible expense.

indirect. Like the current “water’s edge” interest allocation under section 864(c),² such a rule may be tolerable in today’s system,³ where the allocation of expenses to foreign income only reduces broadly-defined foreign-source income that is eligible for a foreign tax credit. But a system of direct expense disallowance (or deferral) requires re-thinking these rules. Clearly, no deduction disallowance is appropriate to the extent U.S. G&A expenses are properly charged out to CFCs. But unlike with interest expense, deductions for G&A expense of a domestic corporation that cannot be charged out can only be moved to foreign jurisdictions by moving actual functions and jobs. To the extent that G&A expenses cannot be charged out because they are treated under arm’s length principles as benefiting only the parent corporation, these expenses should be currently deductible in the United States under a worldwide or territorial system.⁴ Failure to allow such a deduction would prevent taxpayers from deducting G&A expense anywhere in the world. Moreover, it would encourage companies to relocate G&A-related headquarters jobs and operations to foreign jurisdictions where they could be fully deductible.

As with interest and G&A expense, there is no tax policy basis for disallowing R&D expense in a territorial tax system. Where a domestic corporation develops intangible property and transfers that property to a foreign affiliate, section 482 (and section 367(d), in the case of a nonrecognition transfer) requires the foreign affiliate to compensate the domestic transferor for the intangible property on an arm’s length basis.

² Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”).

³ The section 861 source-of-income rules require allocation of a portion of G&A expense to foreign-source income even though the arm’s length principle would not permit an actual charge-out of the expense.

⁴ A way to expand the universe of G&A expenses that can be charged out would be to obtain international agreement to permit cost-sharing for G&A expenses, as is currently done for R&D and marketing expenses.

Assuming proper application of section 482, the domestic transferor should take into account both R&D expense and the related intangible income (in the form of a royalty) in calculating its U.S. taxable income. This analysis applies equally in a deferral or a territorial system, meaning there is no basis for deferring or disallowing any portion of R&D expense deductions in either system. Moreover, perhaps even more than with G&A expense, disallowing R&D expense deductions would encourage companies to move valuable R&D jobs to a jurisdiction where R&D expense would be deductible. This is presumably the reason why the Obama Administration limits its expense deferral proposal to interest expense.

Thus, there is a sound basis in tax policy to permit deductions of all major indirect expenses in a territorial system, taking into account refinements of the thin capitalization proposal. The Discussion Draft appropriately permits deduction of these expenses; the limitation of the DRD to 95% of eligible dividends should not be viewed as a substitute for disallowance of deductions for these expenses.

III. Treatment of Gains and Losses on Disposition of Certain Stock

The Discussion Draft's exemption of 95% of a 10% domestic shareholder's gains on disposition of stock in a qualified foreign corporation is an important element of a consistent territorial system. This exemption is needed to maintain the principle, effectuated first and foremost by the 95% DRD, that active foreign earnings are generally exempt from U.S. tax. Failure to allow the exemption for such gains would create tension within the system by taxing foreign affiliate earnings differently depending on whether a shareholder realizes the benefit of those earnings through a dividend or through a sale of stock.

The exemption for gains on qualified foreign corporation stock is consistent with the Code's policy of preventing corporate-level double taxation in the context of domestic stock sales. Through an election under section 338(h)(10), an acquirer of domestic stock can obtain a stepped-up basis in the acquired corporation's assets and avoid potential gain with respect to those assets where the selling consolidated group has already recognized gain with respect to those assets. Although it is not possible to compel a foreign government to tax stock acquisitions as asset acquisitions and give an acquirer of foreign stock a step-up in the basis of the acquired company's assets (as section 338(h)(10) would provide), the Discussion Draft's exemption for sales of foreign stock similarly prevents a potential double tax.

The Discussion Draft appropriately recognizes that exempting gains on the sale of stock is not appropriate where the foreign corporation's income is currently taxed as subpart F foreign personal holding company income. It differentiates foreign corporations earning such income by limiting the exemption to stock in foreign corporations that have not had more than 30% of their assets generate foreign personal holding company income as of the end of any quarter over the prior 3 years. Such a rule creates a huge cliff effect that can apply in a wide variety of situations. As an alternative, I would suggest consideration of an asset look-through approach, akin to a mandatory section 338(g) election, that would effectively limit the exemption to gain on the sale of stock that reflects underlying gains in business assets.⁵

⁵ Depending on the outcome of subpart F reforms, discussed later, one might consider whether gain attributable to assets that give rise to other forms of subpart F income should be taxable rather than eligible for the exemption.

IV. Transition Tax

The Discussion Draft's 5.25% transition tax on a deemed dividend of accumulated deferred foreign earnings is evidently a revenue-raising measure. As a one-time tax on an existing asset stock, it is a relatively efficient tax in that it should not distort economic decision-making in the way that income and other taxes may. Most importantly, it eliminates the lock-out effect for pre-effective date earnings. Nonetheless, considerations of equity and ease of compliance may argue for refining the design of this tax.

As drafted, the 5.25% transition tax would apply to all earnings and profits not previously subject to U.S. tax, regardless of whether those earnings represent available offshore cash. Thus, the tax would apply with respect to earnings and profits that have been invested in overseas operations or used to finance stock or asset acquisitions. Because the transition tax base is broader than available liquid assets, companies may face liquidity issues in paying the transition tax (although the installment payment option may alleviate this burden in certain cases). In addition, for many companies, especially those with longstanding foreign affiliates, determining historical earnings and profits may be challenging. The challenge may be even greater with respect to so-called 10/50 companies for which a 10% domestic shareholder may not have easy access to available records.

One possible alternative to taxing all deferred foreign earnings would be to simply tax, perhaps at a somewhat higher rate to reduce the revenue impact, earnings and profits to the extent of cash and other liquid assets. Note that this alternative would potentially create three categories of foreign earnings—previously taxed earnings, previously

untaxed earnings subject to the transition tax, and previously untaxed earnings invested in a foreign business—and query how the last category of earnings should be treated if distributed.

As an alternative to taxing all deferred earnings or deferred earnings corresponding to available liquid assets, the Committee also might consider tying the transition tax to the current-law rules for the amount characterized as a dividend under section 1248. With respect to a particular CFC, the amount includible under section 1248 is essentially the smaller of the U.S. shareholder’s gain with respect to its stock and the earnings and profits accumulated during the U.S. shareholder’s ownership period for that stock. In many circumstances, since the amount included under section 1248 is limited to stock gain, it may be an easier amount to determine than all deferred earnings and profits. Additionally, applying the transition tax to the amount included under section 1248 may be more equitable, since it would limit application of the transition tax to a shareholder’s actual economic gain with respect to its foreign affiliates.

As a simplification, I also would suggest limiting the transition tax to that portion of the amount included under section 1248 that reflects “post-1986 undistributed earnings” as defined in section 902(c)(1). Since the Tax Reform Act of 1986, U.S. multinationals have had to keep records of cumulative earnings and profits for most, if not all, CFCs for foreign tax credit calculation purposes. For prior earnings (likely to be relatively small in amount), record keeping can be a real issue.

I also would highlight an apparent technical glitch with respect to the scope of the transition tax. As currently drafted, the transition tax properly excludes from its scope “subpart F income” previously taxed under section 951(a). Note, however, that the term

“subpart F income,” as defined in section 952(a), does not include earnings taxed under section 956, and possibly not earnings taxed under section 1248 or section 964(c). I assume that the Committee intends for all previously taxed earnings to be excluded from the transition tax.

V. Foreign Tax Credit Modifications

In permitting a 95% DRD for foreign-source dividends and eliminating the section 902 foreign tax credit with respect to income eligible for the DRD, the Discussion Draft would fundamentally change the role of the foreign tax credit in the U.S. system. This achieves an important goal given the incredible complexity of our current system and the cross-crediting planning it permits. Although a foreign tax credit no longer would be necessary to relieve double taxation with respect to DRD-eligible dividends, the credit would remain essential for relieving double taxation with respect to foreign taxes imposed on income subject to current U.S. tax. Thus, as the Discussion Draft provides, a foreign tax credit should be available with respect to foreign taxes imposed on amounts included under subpart F and with respect to foreign withholding tax on payments (other than DRD-eligible dividends) from foreign parties to a U.S. company.

Given the limited situations where foreign tax credits would be available, changes to the section 904 limitation such as those in the Discussion Draft are appropriate. Aspects of the section 904 limitation such as basketing of income and foreign tax credits and allocation of expenses, as well as the new anti-splitter rules at section 909, add considerable complexity to the international tax regime. These aspects may be eliminated where other elements of the Discussion Draft are sufficient to ensure that the overall purposes of the section 904 limitation are satisfied. Given the importance of eliminating

cross-crediting and the separation of credit from income as a goal of international tax reform, however, changes to sections 904 and 909 should be done in a way that prevents these activities going forward even if the result causes some residual complexity in the system.

VI. Base Erosion Options

In putting forth the three so-called “base erosion” options for taxing certain income subject to low foreign tax, the Discussion Draft begins an important discussion about the proper scope of subpart F. That discussion should be expanded to include other aspects of subpart F as well. In particular, the scope of any active finance exception, the role of the related party look through rules, and the policies behind subpart F services and sales income should all be re-examined.

Subpart F is the product of decades of legislative compromise that has as one of its lessons the need for great care when expanding current taxation to income from active businesses, especially where foreign countries do not impose similar rules on their multinational companies. Drifting outside of the mainstream can have serious consequences for competitiveness of U.S. companies and industries, as for example where the effective deferral regime for shipping income was repealed as part of the 1986 Act. The historical treatment of active financing income under subpart F is also instructive on this point. With these lessons in mind, the Discussion Draft’s options for expanding subpart F should be evaluated in light of international norms.

Before exploring each of the Discussion Draft’s options individually, I want to address a notion that seems to form part of the motivation for broadening subpart F. No doubt, the Committee has often heard warnings that under a territorial system incentives

for U.S. taxpayers to transfer intangibles and other income-producing assets abroad would increase dramatically. Notwithstanding these warnings, I simply do not see the incentives under a territorial system as substantially different than under current law. In general, U.S.-based companies already effectively enjoy exemption with respect to the large share of their foreign earnings that they treat as permanently reinvested abroad. Moreover, the reduction of foreign tax rates over the past 5 years has resulted in most U.S. multinationals paying some substantial U.S. tax on their royalty income, thereby providing, on the margin, a strong incentive to minimize royalty income consistent with U.S. transfer pricing rules. In practice, a territorial system may only alter transfer pricing incentives for smaller companies that have relatively greater domestic cash needs and fewer borrowing options. For larger taxpayers and the bulk of income, incentives to shift functions, activities, and intangible property offshore likely would not differ appreciably under a territorial system as compared to the current deferral regime. Nonetheless, in the context of international tax reform and the adoption of a territorial system, it remains important to consider the proper scope of subpart F.

A. Option A: Excess Intangible Income Taxed Under Subpart F

Option A, which would treat certain “excess intangible income” subject to low foreign tax as a new category of subpart F income, is conceptually flawed and if adopted would create perverse incentives to move the location of various functions and expenses. The result is a system that is generous to certain classes of taxpayers, but onerous for others. The provision’s core problem lies in the definition of excess intangible income, which fails to take into account the inherent nature of investment in research and development and to differentiate among differing types of costs. As defined in Option A,

excess intangible income is essentially current-year gross income from intangible property less 150% of current-year costs properly allocated to such intangible income. In effect, this definition limits a CFC to a 50% return on its specified costs and treats any income beyond that as excess intangible income.

The first fundamental problem with Option A is that, in capping a CFC's return at a percentage of its current-year costs for purposes of determining excess intangible income, it does not provide the CFC with a return related to the risk it undertook in funding the R&D in prior years. As an example, think of a CFC that develops and brings to market a pharmaceutical compound to which it acquired rights during an early-stage development period. If the product is successful, Option A would subject to current U.S. tax as "excess" income most of the CFC's return to risk-taking undertaken in prior years. In effect, the U.S. would be taxing income earned from successful intangible development without even granting a deduction for prior intangible development costs.

Moreover, notwithstanding the requirement that some U.S. intangible transfer or risk-sharing agreement occur, Option A does not differentiate situations where if income is shifted at all, it is largely, if not completely, shifted from other foreign countries, not the U.S. As discussed above, tax planning to reduce foreign taxes should be encouraged, not punished.

Option A also provides a huge incentive for U.S. multinationals to push routine sales and marketing-type costs into CFCs earning excess returns in order to minimize the impact of the provision. That can mean moving functions (and jobs) from other jurisdictions, including the U.S.

Finally, in expanding subpart F to active business income from intangibles developed by a CFC, Option A would put the United States outside the international norm for territorial systems. Doing so could have significant competitive implications for U.S. companies, since Option A could subject a large share of U.S. companies' intangible income to current U.S. tax while foreign-based multinationals generally may enjoy exemption with respect to their foreign intangible income.

B. Option B: Low-Tax Cross-Border Income Taxed Under Subpart F

Option B represents a general policy of subjecting low-taxed foreign earnings to current U.S. tax under subpart F. For Option B in particular, the “base erosion” terminology is misleading, as this option, in its present form, primarily sets a local tax rate threshold for exemption of foreign earnings. Relative to Options A and C, both of which require a problematic determination of what income is attributable to the exploitation of intangibles, Option B may be appealing for its simplicity. It may also be attractive for applying in a more equitable manner across industries than a provision like Option A or C that is focused on intangible income.

Notwithstanding its simplicity and broad coverage, Option B overreaches relative to the CFC regimes of other countries with a territorial system. Japan's CFC rules, on which Option B appears to be modeled, include a broad exception for a CFC's income from operations in its home country if the CFC has a substantial physical presence as well as local management and operations in that country. The comparable home-country exception in Option B includes an additional requirement that limits the exception to income from sales that ultimately serve the CFC's home-country market. Most U.S. multinationals operate globally. Manufacturing and, in many cases, the provision of

services are done in a few locations or even a single location to serve a regional market or even global markets. The requirement that a manufacturer, for example, only sell into its local-country market is simply unrealistic. As a result under Option B, a very substantial amount of foreign earnings would be subject to current U.S. tax, unless a relatively low foreign tax rate threshold were included. To stay within the mainstream of practice among major countries with territorial regimes, the additional local-country requirement should be omitted if Option B is pursued.

It also should be noted that if Option B does apply to a broad category of business income, setting a foreign tax rate threshold for categorization of income as subpart F income could encourage certain smaller jurisdictions with a substantial U.S. multinational presence to raise their tax rates. Doing so could benefit both the U.S. company, whose income would avoid current taxation under subpart F, and the foreign jurisdiction itself, which would enjoy greater revenue at the expense of the U.S. fisc.⁶ Narrowing the scope of Option B by omitting the local market restriction as described above would reduce the incentive for any foreign jurisdiction to raise tax rates.

C. Option C: Reduced Rate for Foreign Intangible Income; Intangible Income Taxed Under Subpart F

Option C, which would subject low-tax foreign intangible income to subpart F but offer a lower rate for all intangible income, is an interesting alternative to Options A and B. Like Option A, Option C could generate significant controversy over what income should be considered intangible income. Because identification of income as intangible

⁶ Options A and C present a similar incentive, although perhaps to a lesser degree than Option B because of the broad reach of Option B to CFC business income in a world of global markets.

income would have both positive (lower tax rate on all intangible income) and negative (current inclusion of CFC intangible income under subpart F) aspects for taxpayers, however, controversy between the IRS and taxpayers about the scope of intangible income could be moderated relative to controversy under Option C.

A significant feature of Option C is the availability of a reduced tax rate for all foreign intangible income, including income earned directly by a domestic corporation and CFC income included in a U.S. shareholder's income under subpart F. By treating subpart F and other income consistently, Option C theoretically mitigates any incentive to transfer or develop intangibles offshore versus maintaining beneficial ownership of intangibles in the United States. As the Discussion Draft is written, CFC intangible income subject to a 13.5% foreign effective tax rate would be exempt from U.S. tax and so would enjoy a modest 1.5% benefit compared to intangible income earned directly by the CFC's U.S. shareholder. However, the U.S. shareholder could deduct its R&D expenses against income taxed at the 25% (or higher) corporate rate, thus providing a large incentive for development funding in the U.S. This feature helps assure that the U.S. tax system would not create an incentive to move R&D offshore.

Because Option C currently taxes all intangible income under subpart F, albeit at a reduced rate, care should be taken to ensure that the overall burden on intangible income is consistent with international norms. Option C's viability and ultimate effect on competitiveness would depend on the exact tax rates and thresholds chosen and how those compare to the tax burden of foreign-based multinationals with respect to their intangible income.

VII. Interest Expense Deduction Disallowance

The Discussion Draft would create new thin capitalization rules to deny interest deductions to the extent a domestic corporation is considered to have excess domestic indebtedness. As I discussed earlier, all interest expense represents a real cost of earning income and should be deductible against taxable income in some jurisdiction. A properly designed thin capitalization provision should provide a path for taxpayers to generate interest deductions in foreign jurisdictions as a way of avoiding an interest deduction disallowance in the United States. The Discussion Draft applies its debt-equity thin capitalization regime to net interest in excess of some percentage of adjusted taxable income. Such a rule makes sense on the theory that at modest levels of interest expense the complexity of a debt-equity analysis is not worth the effort.

At a more technical level, there are two features that I believe an interest disallowance provision should incorporate. First, an interest disallowance provision should operate based on net interest, as the Discussion Draft does for both its adjusted taxable income and its debt-equity tests. Second, to ensure taxpayers can obtain an interest expense deduction in some jurisdiction, parent borrowing and on-lending to a CFC should be treated in the same way as if the CFC had directly borrowed from a third party under the debt-equity test.

Taking into account net interest expense, as the Discussion Draft and current section 163(j) earnings-stripping rules do (but the section 861 income source rules do not), appropriately recognizes the close relationship between interest income and expense. In the financial sector, where the core business activity involves earning a spread by lending at a higher interest rate than the interest rate paid on borrowing, the relationship

between interest expense and income is most evident. A similarly close relationship exists where a company accumulates liquid interest-bearing securities to pay off term debt. In these cases and others, allocating net interest expense acknowledges the close factual relationship between interest income and expense. Disallowing interest expense deductions on a gross basis would have a disproportionate negative impact on industries (like the financial service industry) with greater interest income and could harm U.S. competitiveness in those industries.⁷

To ensure taxpayers can deduct interest expense in the appropriate jurisdiction, the Discussion Draft's debt-equity interest disallowance provision should be refined. For a variety of reasons, it is frequently easier, more efficient, and more affordable for a U.S. company to borrow on behalf of its entire worldwide group than for its CFC to borrow on its own behalf. Accordingly, an interest disallowance provision should allow domestic corporations that borrow from unrelated parties to lend to their foreign affiliates with the same consequences as if the CFC borrowed directly from a third party with a parent guarantee. Allowing this flexibility brings no harm to the U.S. tax base (assuming arm's-length interest rates), since interest income paid to the parent by the CFC offsets the parent's interest deductions with respect to the on-lent portion of third-party borrowing. Because the interest disallowance provision in the Discussion Draft does not net a domestic corporation's loans to its CFCs with its third-party indebtedness in determining excess domestic indebtedness, a domestic corporation that incurs third-party debt and also lends to its CFCs could suffer interest disallowance that would not occur if its CFC had borrowed directly from a third party. Thus, under the Discussion Draft, a U.S.

⁷ Indeed, consideration should be given to netting not just interest income but other forms of passive income, such as leasing income, against interest expense.

taxpayer may be forced to choose between non-deductible interest expense and costly direct borrowing from third parties by its CFCs. There are a number of possible technical refinements that would remedy this consequence of the Discussion Draft's interest disallowance provision; one of them should be adopted.

VIII. Conclusion

The Discussion Draft makes great strides toward remedying the unsustainable aspects of the current U.S. international tax regime—namely, the lock-out effect inherent in deferral and the ability to cross-credit—and establishing a system that is consistent with the international tax regimes of other major countries. Many significant design issues, including most importantly the scope of subpart F, must be discussed and addressed. Doing so will require a balancing of important tax policy goals. Nonetheless, the Discussion Draft represents a very good start toward meeting the difficult challenge of reforming the international tax system in a balanced and sustainable way.

Chairman TIBERI. Thank you.
Mr. Sullivan is recognized for five minutes.

**STATEMENT OF MARTIN A. SULLIVAN, CONTRIBUTING
EDITOR, TAX ANALYSTS, ALEXANDRIA, VIRGINIA**

Mr. SULLIVAN. Thank you, Mr. Chairman, Ranking Member Neal, and Members of the Committee. Mr. Chairman, there is no doubt about it. U.S. multinationals play an invaluable role in the American economy. They are export-intensive, they provide millions of high-paying jobs, they do most of the nation's research and development. It is certainly not in America's interest to let its multinationals be at a competitive disadvantage.

But we must not forget that multinational corporations are only part of the American economy. And multinational competitiveness is not an end, in and of itself. A far more important objective is to promote the overall competitiveness of the economy. Too often in Washington, the term "competitiveness" is equated with competitiveness of multinationals, and this is a serious mistake.

Our goal is job creation through tax reform. We cannot neglect small businesses, we cannot neglect large and mid-sized businesses that do not have foreign operations, but nevertheless do compete internationally with their exports on foreign markets and with imports into the United States. And finally, we also want to encourage job-creating foreign companies to locate in the U.S.

Tax policies that only promote the interests of multinationals are a double whammy to the rest of the economy for two reasons. First, they create a tax-induced tilt to the playing field that shifts resources away from domestic business. This reduces the productivity of the overall economy. And second, now that we have extremely tight budgets that require tax reform to be revenue-neutral, or perhaps even revenue raising, any tax cuts for domestic operations of a multinational—any tax cuts for foreign operations of multinationals are likely to result in tax increases for domestic business.

U.S. tax rules give multinationals a large incentive to shift production offshore. This incentive is growing, and it is much larger than most folks realize. That is because we are not just talking about the difference between 35 percent in the U.S. and 12.5 percent in Ireland. The ease with which a multinational can shift profits turbo-charges the incentive of that rate differential. A toehold of real investment allows a truckload of profit to follow. The net effect is that the marginal effective rate on foreign investment is driven below zero. This is corporate welfare, plain and simple. It is no different than the Department of Commerce sending subsidy checks to companies. And the worst part of it is that the checks only go to companies that invest abroad.

For obvious reasons, it has been customary throughout our history to limit business tax incentives like the investment credit and the research credit to domestic business activities. From this perspective, it is mind-boggling that one part of our Tax Code does the exact opposite. Our international tax rules provide a tax incentive exclusively for foreign investment and exclusively for foreign job creation.

If we do want to promote the competitiveness of our multinationals, there are better ways than expanding foreign tax breaks. Our multinationals have a domestic side and a foreign side. We should focus tax benefits on the domestic side. In addition, we must

not forget that providing tax benefits to domestic suppliers also improves the competitiveness of our multinationals.

The U.S. has a worldwide system. Most other countries have territorial systems. To those who are unschooled in the realities of international tax, these circumstances imply that U.S. multinationals are at a huge disadvantage compared to other multinationals. But this just is not the case.

One recent study compared the top 100 U.S. multinationals to the top 100 multinationals in the EU. Well, who had the higher tax rate? The EU multinationals had 31 percent; the U.S. had 24 percent. No competitive disadvantage there. This result is not surprising for those of us who work with the data. We can readily observe that multinationals pay low tax—low rates of foreign tax, and we can also readily see that multinationals with foreign operations have low overall effective tax rates.

We also know that territorial systems employed in other countries are not pure territorial systems that exempt all foreign profits. Many countries do not allow exemptions if profits are from low-tax jurisdictions, which brings us to the chairman's proposal.

The chairman has been emphatic that the proposal should be revenue-neutral. Territorial systems that do not bleed revenue losses cannot simply exempt foreign profits from the U.S. tax base. In order to protect the domestic tax base, they need backstops and anti-abuse rules, which the rest of the panel has discussed.

The chairman has wisely included several features in the draft to prevent base erosion and maintain revenue neutrality. These provisions would prevent an exacerbation of the economic problems that we now experience under current law. In particular, the so-called base erosion features of the plan are essential. The draft offers three options.

I urge the committee to pursue the simplest option, option B. It would not spark endless disputes about the definitions of intangible income, and it would, for once—once and for all, eliminate the spectacle of mailbox holding companies and tax havens booking billions of profits.

The chairman has stressed—in conclusion, the chairman has stressed that the rate reduction is an integral part of his plan. As someone who has crunched a lot of numbers in and out of government, it is hard to be optimistic about getting to 25 percent. In the 1980s, Congress started the tax reform process with President Reagan's blessing to repeal the investment tax credit. Translated into today's terms, that gave tax reformers about \$100 billion of annual revenue for rate reduction.

We don't have anything like that now. On the contrary, repeal of the current top three corporate tax expenditures—accelerated depreciation, Section 199, and the research credit—would only get us to about 30 percent. Furthermore, because the primary beneficiaries of these expenditures are manufacturers, this type of revenue-neutral reform would be a tax increase on America's manufacturers.

So, where is the money going to come from to pay for the 25 percent rate? Value-added tax? Limiting deductions on corporate debt? Increasing the tax rate on capital gains? Well, of course, I understand these are non-starters in today's political environment. But

if we are talking about a 25 percent rate, that is where the numbers lead you.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Sullivan follows:]

Testimony of Martin A. Sullivan, Ph.D.

**Economist and Contributing Editor
Tax Analysts¹
www.tax.org and www.tax.com**

**Before the Committee on Ways and Means
U.S. House of Representatives**

November 17, 2011

Hearing on International Tax Reform

Good morning, Chairman Tiberi, Ranking Member Neal, and members of the Committee. Thank you for this opportunity to share my views on a topic of critical importance to the long-term competitiveness of the U.S. economy.² My testimony will comment on corporate tax reform as it relates to international reform, on the various approaches to territorial taxation, and about Chairman Camp's draft proposal to exempt the profits generated from U.S.-owned foreign business operations from U.S. tax.

I. Tax Reform Should Promote Competitiveness of the Entire Economy

U.S. multinational corporations play an invaluable role in the American economy. They are research and export intensive, and they provide tens of millions of high-paying jobs. Their worldwide distribution networks increase demand for domestic research, high-tech manufacturing, and management services. It is not in the interest of the United States to have multinationals' headquarters go abroad or for them to be at a competitive disadvantage to foreign-headquartered multinationals. We should always remain vigilant to problem, but as of now there is little evidence U.S. multinationals are going abroad² and there is little evidence that U.S. multinationals suffer significant tax disadvantages vis-à-vis foreign headquartered multinationals.³

Moreover, multinational corporations are only a part of the American economy. Multinational competitiveness is not an end unto itself. The competitiveness of the entire economy is what is critical to standard-of-living of the American people. If job creation through tax reform is our goal, we cannot neglect small business. We cannot neglect large and mid-sized business that do not have foreign operation but nevertheless compete internationally (with their exports on foreign markets and with imports into the United States). We cannot close the door to highly mobile job-creating foreign companies that clearly have opportunity to locate their factories elsewhere.

¹ The views here are my own and not those of Tax Analysts. Founded in 1970 as a nonprofit organization, Tax Analysts is a leading provider of tax news and analysis for the global community. By working for the transparency of tax rules, fostering increased dialogue between taxing authorities and taxpayers, and providing forums for education and debate, Tax Analysts encourages the creation of tax systems that are fairer, simpler, and more economically efficient.

² Eric J. Allen and Susan C. Morse, "Firm Incorporation Outside the U.S.: No Exodus Yet," October 28, 2011, available on-line at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1950760.

³ See section II below for more detail.

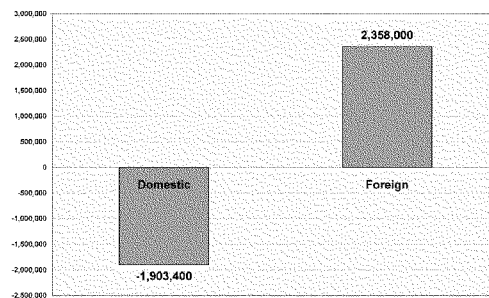
Too often in Washington D.C. the term “competitiveness” is equated to the “competitiveness of multinationals.” This is a serious mistake. A far more important objective is promoting the overall competitiveness of the U.S. economy.⁴ Tax policies that only promote the interests of multinationals are a double whammy on the rest of the economy—for two reasons.

First, this tax-induced tilt of the playing field shifts economic resources to multinationals and away from the rest of the economy. This not only hurts small business but it hurts the overall economy because government rules get in the way of efficient free-market outcomes. Whatever the positive effects are to the United States of promoting the success its homegrown multinationals, it is outweighed by the economic costs of distorted investment decisions.

And second, now that we have extremely tight budgets that require tax reform to be revenue-neutral—or perhaps even revenue-raising—any tax cuts for foreign operations of U.S. business are likely to mean tax increases for domestic business.

The best way for tax policy to promote domestic economic growth is to reform the tax system so that all job-creating sectors of the economy are taxed evenly. Therefore, if the Congress has opportunity to reform corporate taxes it would be far better to reduce our high corporate tax rate (which would be a direct incentive for domestic job creation) rather than make our already generous foreign tax rules even more favorable (which would be a direct incentive for foreign job creation).

U.S. Multinational Job Creation, 1999-2008



Source: Bureau of Economic Analysis, U.S. Department of Commerce.

Proponents of reduced taxes on foreign operations of U.S. companies like to argue that direct stimulus to foreign job creation will indirectly benefit U.S. job creation. Proponents of reduced taxes on foreign operations of U.S. companies like to argue that direct incentives for foreign job creation will indirectly benefit U.S. job creation. I like to refer to this as trickle-sideways

⁴ In 1991 the Ways and Means Committee held nine day of hearings on international competitiveness. For further discussion of the different definitions of competitiveness, see the JCT background pamphlet for those hearings the JCT: Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States*, JCS-6-91, May 30, 1991.

economics, a notion we should find no more compelling than trickle-down economics. In a purely domestic context, trickle-sideways proponents would argue, for example, that subsidies for businesses in Kentucky will increase job creation in Ohio. But this is an incomplete story that fails to address who is losing a job and who is getting a job. While it is true that the subsidies in Kentucky might result in some new jobs in Ohio, that fact would be cold comfort for the workers whose positions were moved Kentucky. Moreover, current Ohio residents (including those whose jobs were moved) would not necessarily be the ones to fill the newly created jobs. Finally, such a policy would be particularly hard for Ohio residents to stomach if they are the ones being asked to foot the bill for the subsidies in Kentucky.

A territorial tax system is not all that different from the hypothetical subsidy for jobs in Kentucky paid for by taxpayers in Ohio. A territorial system is the elimination of tax on foreign operations of U.S. corporations—a subsidy for overseas job creation. The data simply do not support the trickle-sideways theory. Even with the less generous subsidies offered under the present system (deferral as opposed to exemption) the jobs have gone offshore. As shown in the figure below, between 1999 and 2008, U.S. multinational corporations cut their domestic employment by 1.9 million. Over the same period U.S. multinationals increased their employment overseas by 2.4 million.

II. Multinationals Pay Low Taxes

Current U.S. tax rules provide large tax benefits to foreign operations of U.S. companies that are not available for business operations inside the United States. The favorable treatment of foreign profits (and U.S. profits booked in foreign locations) is the result of a combination of factors, including: (1) the ability to easily shift profits out of the United States and into tax havens; (2) the exemption of unrepatriated foreign profits from U.S. tax until those profits are distributed to U.S. parent company (“deferral”); and (3) the ability for most repatriated profits to escape U.S. tax through skillful use of foreign tax credit rules.

Over the past decade the effective tax rates of U.S. corporations have declined significantly. As shown in the table below in less than a dozen years the average effective rate of America’s 20 most profitable corporations has dropped by 5.5 percentage points—from 35.8 percent during the 1997-99 period to 30.3 percent during the 2005-07 period.⁵ These declines have little to do with tax credits and deductions for domestic business operations. They are primarily the result of ever more favorable tax treatment of foreign profits.⁶ U.S. corporations do not need to employ complex tax shelters as they did in the 1990s in order to lower their tax rates. All they need to do is move operations offshore and shift profits there.

According to the IRS, foreign subsidiaries of U.S. corporations paid an average rate of *foreign* tax of 16.4 percent in 2006.⁷ In 2010 Cisco Systems, Apple Computer, Amgen, and Google all

⁵ Martin A. Sullivan, *Corporate Tax Reform: Taxing Profits in the 21st Century*, APress, 2011, Table 2.1.

⁶ Martin A. Sullivan, “Why Reported Effective Corporate Tax Rates Are Falling,” *Tax Notes*, March 3, 2008.

⁷ Lee Mahony and Randy Miller, “Controlled Foreign Corporations, 2006,” *Statistics of Income Bulletin*, winter, 2011, Table 1. This figure is for the approximately 7500 largest controlled foreign corporations with positive foreign earnings. Data from 2006 are the most recent available.

reported foreign effective tax rates of 5 percent or below.⁸ By shifting profits to holding companies in tax havens, foreign effective tax rates can be held far below the rates of tax of the foreign countries where business operations of multinationals actually are located.⁹

The Declining Effective Tax Rates of America's Most Profitable Corporations				
Corporation	Book Profits (billions)	Reported Effective Tax Rate		
		1997-99 Average	2005-07 Average	Change
Altria	\$9.8	40.3%	29.6%	-10.7%
AT&T	\$12.0	37.7%	27.7%	-10.0%
Bank of America	\$15.0	36.4%	31.7%	-4.7%
Berkshire Hathaway	\$13.2	33.4%	32.7%	-0.7%
Chevron	\$18.7	47.6%	44.1%	-3.5%
Cisco Systems	\$7.3	40.9%	26.0%	-14.9%
ConocoPhillips	\$11.9	47.3%	45.4%	-1.9%
Exxon Mobil	\$40.6	36.1%	42.7%	+6.6%
General Electric	\$22.2	29.6%	16.8%	-12.8%
Goldman Sachs	\$11.6	n.a.	33.5%	
Hewlett-Packard	\$7.3	27.7%	22.3%	-5.4%
IBM	\$10.4	32.3%	30.7%	-1.6%
Intel	\$7.0	34.3%	27.9%	-6.4%
J. P. Morgan Chase	\$15.4	36.2%	31.4%	-4.8%
Johnson & Johnson	\$10.6	27.9%	22.6%	-5.3%
Microsoft	\$14.1	35.6%	29.0%	-6.6%
Pfizer	\$8.1	26.6%	18.6%	-8.0%
Procter & Gamble	\$10.3	34.7%	30.1%	-4.6%
Wal-Mart Stores	\$12.7	35.7%	33.6%	-2.1%
Wells Fargo	\$8.1	39.4%	32.6%	-6.8%
Group Average*		35.8%	30.3%	-5.5%

* Excluding Goldman Sachs. It was not a publicly traded company in the 1990s.
Source: Company annual reports.

The observation is often made that the United States is one of the few major economies that has a worldwide system of international tax (where, in theory, all multinational profits are subject to U.S. tax) and has not adopted a territorial system (where, in theory, all foreign profit is exempt from tax). To those unschooled in the realities of international tax, this observation implies that U.S. multinationals are at significant competitive disadvantage with foreign multinationals. But this is not the case.

⁸ Martin A. Sullivan, "Foreign Tax Profile of Top 50 U.S. Companies," *Tax Notes*, July 25, 2011.

⁹ Widespread foreign-to-foreign profit shifting—made possible by the Clinton Treasury's adoption of check-the-box rules—has greatly reduced multinationals' overall foreign effective tax rates. This makes shifting profit out of the United States to almost any foreign location lucrative. This important point has been highlighted by Edward Kleinbard, former chief of staff of the Joint Committee on Taxation. See, Edward D. Kleinbard, "Stateless Income's Challenge to Tax Policy," *Tax Notes*, September 5, 2011.

First, as we have already noted, U.S. multinationals enjoy major benefits under our current worldwide system. The benefits of current law are so large that in 2005—when both the Joint Committee on Taxation and the President Bush’s Advisory Board for Tax Reform released proposals for moving the United States to a territorial system—both of these plan were scored to *raise* revenue.¹⁰ Based on these estimates we can conclude that current law is more generous to multinationals than would be an exemption system that correctly measures foreign source income.

Second, territorial systems employed in other countries are not “pure” territorial systems that provide exemption for all foreign profits from active business. Many countries do not allow exemption if profits are generated in low-tax jurisdictions at excessively high rates of return. They may also disallow domestic interest deductions if interest deductions are disproportionately large relative to foreign interest deductions.

Data confirm that the United States, despite its retaining a worldwide system, has international tax rules that are as generous as those nations with territorial systems, despite their adoption of territorial systems. One recent study compared the 100 top U.S. multinationals and the 100 top multinationals based in the European Union. Over the 2001-2010 the average rate for an EU multinational was 35 percent compared to an average rate of 31 percent for U.S. multinationals. For 2010, the average rate for EU multinational was 31 percent compared to 24 percent for U.S. multinationals. There have been numerous other studies making international comparisons of corporate effective tax rates.¹¹ Any specific conclusions about the relative tax advantages of U.S. versus foreign multinationals depend on the precise details of how the economic analyses are constructed and data samples are collected. However, a fair reading of the existing research that in general U.S. multinationals do not suffer any significant competitive disadvantages relative to their foreign competitors.

III. Lost Revenue, Lost Jobs

The ease of shifting profits out of the United States (either directly into tax havens or first into other major economies and then into tax havens) results in large revenue losses to the U.S. Treasury. It is hard to pin down a precise figure, but estimates between \$30 and \$60 billion annually seem reasonable.¹²

By allowing inappropriate transfer pricing, the IRS—an agency of the U.S. government—is providing subsidies for investment and job creation outside of the United States. It is no different than, say, the Department of Commerce sending checks directly to companies for investing abroad instead of the United States. This is not only corporate welfare. It is corporate welfare detrimental to the interest of U.S. workers. It remains largely hidden from public view by the complexity of the rules and the lack of disclosure by multinationals.

¹⁰ President's Advisory Panel on Federal Tax Reform, Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System, Report of the President's Advisory Panel on Federal Tax Reform, November 2005; and Joint Committee on Taxation, Options to Improve Tax Compliance and Reform Tax Expenditures, JCS-02-05, Jan. 27, 2005.

¹¹ See Jane G. Gravelle, “International Corporate Tax Rate Comparisons and Policy Implications,” Congressional Research Service, March 31, 2011.

¹² Martin A. Sullivan, “Transfer Pricing Costs U.S. at Least \$28 Billion,” *Tax Notes*, Mar. 22, 2010; and Kimberly A. Clausing, “The Revenue Effects of Multinational Firm Income Shifting,” *Tax Notes*, Mar. 28, 2011.

In addition to the revenue problem there is the jobs problem. A combination of factors makes the incentive for foreign job creation far larger than the differential between U.S. and foreign tax rates might suggest. U.S. companies investing abroad usually pay foreign tax at rate far below the rates of the countries in which they invest. That's because it is easy for them to shift profits from moderate-tax countries where they do business to pure tax havens. That's bad enough. But this is not the end of the story. A toehold of real investment allows a truckload of profit to follow. Once a multinational establishes a foreign business it becomes a magnet for movable profits. Lax U.S. rules allow what should be domestic profit to be shifted out of the United States to foreign jurisdiction where it only subject to low foreign tax. This ability to shift profits out of the United States turbo-charges the U.S. tax incentive for foreign investment. In many cases, the marginal effective rate on foreign investment is driven below zero.

For obvious reasons throughout our history it is customary to limit business tax incentives (e.g., investment credits, research credits, jobs credits) to domestic business activities. But our foreign tax rules do just the opposite. In effect, U.S. foreign tax rules provide a foreign tax credit exclusively for foreign investment and foreign job creation.¹³

In a revenue neutral tax reform, if tax benefits are targeted to foreign operations of U.S. businesses, other American businesses are left out in the cold. These include small businesses, mid-size and large companies with mostly domestic operations, and foreign-owned businesses that want to locate factories in the United States

But let's say Congress does decide to promote the competitiveness of multinationals over other domestic businesses. Tax benefits for foreign operations are not the only means of promoting multinational competitiveness. U.S. multinationals have a domestic side and a foreign side. At every opportunity Congress should favor the domestic over the foreign side. Providing tax benefits to domestic suppliers also would improve the competitiveness of U.S. multinationals. Policies like reductions in the corporate tax rate and expansion of the research credit would increase multinational competitiveness by strengthening the multinationals' domestic supply chain and encouraging expansion of domestic operations.¹⁴

IV. Territorial System That Cuts Multinational Taxes

U.S. multinationals are not interested in territorial systems like those proposed in 2005 by the President's Advisory Panel and Joint Committee on Taxation. These proposals are an overall tax

¹³ In his 2003 paper Treasury economist Harry Grubert points out the companies with the most opportunity for profit shifting are companies with lots of research intangibles. Grubert finds that not only are these companies engaged in profit shifting, but that the combination of low taxes and the ability to shift income creates a significant incentive to locate jobs and investment in low-tax countries. ("Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location," *National Tax Journal*, Vol. LVI, No. 1, Part 2, p. 221, March 2003.)

¹⁴ Along these lines Michael Durst, former director of the IRS Advanced Pricing Agreement program, has proposed a tax reform that would include a reduction in the corporate tax rate to 15 percent, elimination of opportunities to shift income to tax havens, and large reductions in tax expenditures. His goal is to increase U.S. job creation. This would occur both through the effects of the lower rate and through the elimination current tax haven techniques that encourage job creation outside instead of within the United States. Michael C. Durst, "An Employment, Equity, and Competitiveness Tax Act," *Tax Notes*, September 26, 2011

increase. Nor do U.S. multinationals want a territorial system that is revenue-neutral relative to current law. They want a territorial system that reduces their taxes.

But cutting taxes on offshore business with a generous territorial system would be a setback to the overall competitiveness of the U.S. economy. Our system of taxing international business would move from bad to worse. It would tilt the playing field further in favor of offshore job creation and against domestic job creation. And if tax increases on domestic activities are used to pay for a revenue-losing territorial system, the damage to the overall competitiveness of the economy would be exacerbated.

There is one benefit of moving from the current system of deferral to a territorial system. It would eliminate the problem of “trapped” foreign profits. This benefit, however, must be kept in perspective. There is no doubt that “lock-out” is a needless tax barrier to the free movement of retained earnings inside a corporation. But the benefit of unlocking those profits for job creation is not large as advertised, as our experience with the “tax holiday” in 2004 demonstrates.¹⁵ Nor is the burden of keeping those profits offshore as large as many corporations claim. Many multinationals are going to use those funds for foreign investment and don’t need to repatriate. In most cases the inability to tap these funds does not stymie investment and job creation because multinationals have other funding options (including tapping into domestic retained earnings and borrowing at low rates).

The advantage of unlocking foreign profits does not offset the disadvantages of lost revenue and domestic job losses. Unlocking retained foreign profits is not a good justification for moving to a territorial system. Furthermore, there are other ways of unlocking these profits, including moving to a worldwide system.

V. The Chairman’s Draft

On October 26 Chairman Camp unveiled a draft international tax reform bill that would put the United States on a path toward a territorial tax system. The significant rules in the draft language that would prevent profit shifting and the emphasis in the accompanying explanation on preserving revenue-neutrality suggest a territorial plan with teeth.

Territorial systems that do not bleed revenue losses cannot simply exempt foreign profits from U.S. tax. In order to protect the domestic tax base—that is, to prevent wholesale shifting of profits that should be taxed in the United States to tax havens—backstops and anti-abuse rules are a must. There are five features of the Chairman’s draft that serve in this role. If they are ultimately adopted, they could offset the cost of eliminating U.S. tax on foreign profits and make it possible for a territorial system to be revenue-neutral. These will be the flashpoints of future debate on this plan.

Deduction Limited to 95 Percent. The mechanics of the draft gets us to a territorial system not by exempting foreign income from U.S. tax. Instead it allows provides a deduction equal to 95 percent of foreign profits. (So, foreign profits as booked are not actually free of U.S. tax but, with the assumed 25 percent tax rate, they are subject to an effective rate of U.S. tax of 1.25 percent.) The use of a 95 percent deduction instead of a deduction equal to all foreign income is a quick and

¹⁵ Lee A. Sheppard and Martin A. Sullivan, “Repatriation Aid for the Financial Crisis?” *Tax Notes*, January 5, 2009.

easy substitute for the full-blown accounting rules that would be needed to properly measure foreign profit.

One of the most basic tenets of accounting is that proper measurement of income requires matching revenues with expenses. Many deductions for activities on U.S. soil should properly be allocated to foreign income. For example, if one quarter of U.S. headquarters' efforts is devoted to foreign operations, one quarter of headquarters expense should be allocated to foreign profit. Otherwise, foreign profits—now exempt—are overstated.

The 5 percent haircut on the deduction for foreign income is a crude approximation. It is only correct if expenses properly allocated to foreign income are equal to 5 percent of foreign income. Companies with deducting a lot of expenses in the U.S. that benefit foreign income benefit from this rough justice approach.

Both Japan and the United Kingdom adopted territorial systems in 2009. Japan limited its exemption to 95 percent of foreign income just as the Camp draft suggests. The new U.K. system does not have any limitation.

Branches Treated as Corporations. Foreign affiliates of U.S. corporations can be organized as branches or as corporations. Organizing as a foreign corporation has the huge advantage of allowing U.S. tax to be deferred until profits are repatriated. If, however, the foreign affiliate has losses, branches have advantages over corporations because losses can be deducted immediately. Under the proposal losses of foreign branches would no longer have the advantages they have under current law.

Tax on Previously Accumulated Earnings. Multinationals are lobbying for a temporary 5.25 percent tax on whatever portion of those \$1.3 trillion of accumulated foreign earnings they chose to repatriate. Under the proposal, there would be a 5.25 percent tax on all those earnings whether or not they are repatriated. (Unrepatriated earnings that subsequently repatriated would be treated like post-effective date foreign earnings.) Multinationals would have the option of paying this tax (plus interest) over 8 years. There is nothing magical about the 5.25 percent rate. It can be raised or reduced depending on how much revenue needs to be raised. Changing the rate will not change the amount of repatriations because the amount of tax does not depend on the amount repatriated.

Limits on Domestic Interest Deductions. Under the proposal, domestic interest deductions would be limited to the extent the domestic debt-equity ratio exceeded the foreign debt-equity ratio and to the extent interest deductions exceed some yet-to-be-determined percentage of gross income. Depending on the details, this provision could raise a little or a lot of revenue. As Congress desperately searches for new revenue, limitations on interest deductions deserve serious attention from Congress, not just as a component of international reform, but also as a component of corporate tax reform.

Limits on Benefits for Low-Tax Foreign Income. U.S. transfer pricing rules are sieve. Profits—especially profits from U.S.-developed intangibles—can readily be shifting to low-tax countries and tax havens. Many believe that moving to a territorial system will put even more pressure on U.S. transfer pricing rules. Under current law, one way to reduce aggressive profit shifting is to disallow deferral in situations where transfer pricing abuse is likely to occur. In other countries with territorial systems, transfer pricing abuse is reduced by disallowing territorial benefits in those same situations. The Chairman's draft plan would take the anti-deferral rules in the current

U.S. system and employ them as anti-exemption rules in his system. Moreover, he would add expand the scope of these rules. The general approach of the new rules is that when income is booked in a low-tax country and that income is not related to business operations in that low-tax country, it will be subject to U.S. tax.

The idea for the first of these three alternatives comes from the Obama Administration. In his second and third budgets President Obama has proposed current taxation of foreign profits when income three conditions are met: (1) it is income from an intangible; (2) it is income that exceeds a normal rate of return earns; and (3) it is subject to a low rate of tax.

The Chairman's second alternative is tougher than the first. It would subject all income from low tax countries to current U.S. tax—whether or not it is from an intangible and whether or not it is income that exceeds a normal return. This alternative—particularly if combined with a reduction in the corporate tax rate—would be extremely attractive because it greatly reduce the differential between domestic and foreign investment and would eliminate the lock-out effect.

The third alternative is far less burdensome on U.S. multinationals. It would be deny deferral to all low-tax intangible income earned by a foreign subsidiary but the U.S. parent would only be subject to an effective rate of tax equal to 60 percent of the top statutory rate on that "foreign base company intangible income." If we go along with the Chairman's assumption that the corporate rate has already been reduced to 25 percent, the effective rate on income from intangible assets would be 15 percent.

VI. Paying for a Lower Corporate Rate

It is hard to be optimistic about the prospects for corporate tax reform. It was difficult in 1986 and the conditions for corporate tax reform were much more favorable in 1986 then they are now. In the second half of the 1980s our deficit was under control and the economy was growing. We had a popular second term president with a good working relationship with Congress.

In 1986 Congress reduced the corporate tax rate 12 percentage points—from 46 to 34 percent. What almost everybody forgets it that the 1986 rate reduction was paid for mostly by repeal of the investment tax credit. That credit reduced corporate tax revenues by approximately 25 percent—about \$100 billion annually in today's terms. There is no one big corporate tax expenditure out there right now whose repeal can pay for major rate reduction.

On the contrary, repeal of the current top three corporate tax expenditures—accelerated depreciation, the deduction for domestic production, and the research credit—could only pay for a rate reduction to about 30 percent. And total repeal is highly unlikely given all three have strong support. Furthermore, the beneficiaries of the big three corporate tax expenditures are mainly in the manufacturing sector. Therefore, the main thrust of any revenue-neutral corporate reform effort would be a tax increase on the manufacturing sector offset by a tax cut for other sectors like retail and finance.¹⁶ Revenue-neutral corporate reform will create large winners and losers that will undo the corporate coalition currently supporting reform.

¹⁶ Martin A. Sullivan, "Winners and Losers in Corporate Tax Reform," *Tax Notes*, Feb. 14, 2011.

Not surprisingly, given the lack of attractive options, American business wants Congress to pursue corporate tax reform that is not revenue neutral. Speaking for the Business Roundtable, Robert McDonald, Procter & Gamble CEO, spoke of his concern with revenue-neutral corporate reform when he testified before the full committee revenue on January 20th of this year.¹⁷

But whose ox will be gored to pay for corporate rate reduction? If we want 25 percent corporate rate or even a 30 percent corporate rate, it is almost certain that Congress will have to extract revenue from outside the corporate sector. Here are some of possible revenue sources to pay for the lower corporate rate:

- (1) a carbon tax (as in the United Kingdom¹⁸ and Australia¹⁹);
- (2) a value added tax (VAT rate was recently raised in the United Kingdom²⁰ and there is a proposed rate increase in Japan²¹);
- (3) limiting deduction on corporate debt (as in Germany²² and as proposed under the Wyden-Coates plan²³);
- (4) increasing taxes on individuals, most likely on dividends and capital gains the rate on capital gains and dividends (the United Kingdom has recently increased its capital gains rate²⁴; under Wyden-Coates, those rates would be raised from 15 percent to 22.5 percent²⁵.)

No, I wasn't born yesterday. Yes, I understand these are considered non-starters in today's political environment. But if members of Congress want to talk about a revenue-neutral cut in the corporate rate to 25 percent, these are options that must be considered. To get to a 25 percent corporate tax rate Congress must begin to think outside the box.

* * *

Thank you for this opportunity to comment on this important topic.

¹⁷ For a more recent expression of corporate dissatisfaction with revenue-neutrality, see Richard Rubin, "Manufacturers Resist 'False Choice' in Corporate Tax Overhaul," *Bloomberg*, November 10, 2011.

¹⁸ A "climate change levy" was introduced in the United Kingdom in 2001.

¹⁹ The Australian parliament earlier this month approved a new carbon tax. See, David D. Stewart, "Senate Approves Carbon Tax," *Tax Notes International*, November 14, 2011.

²⁰ The United Kingdom increased its rate of value-added tax from 17.5 to 20 percent on January 4, 2011.

²¹ Prime Minister Yoshihiko Noda has pledged to global leaders to gradually increase the Japan value-added tax rate from its present 5 percent to 10 percent by the mid-2010s. See, Masami Ito, "Noda Will Call Snap Poll If Diet OKs Sales Tax Hike," *Japan Times*, November 5, 2011.

²² Stuart Webber, "Thin Capitalization and Interest Deduction Rules: A Worldwide Survey," *Tax Notes International*, November 29, 2010.

²³ "The Bipartisan Tax Fairness and Simplification Act of 2011," sponsored by U.S. Senators Ron Wyden (D-Ore.) and Dan Coats (R-Ind.) would reduce interest deductions by the amount that interest is due to inflation.

²⁴ On June 23, 2010 the U.K. government raised the capital gains rate for top earners from 18 to 28 percent.

²⁵ Under the Wyden-Coates tax reform plan the tax rate on capital gains and dividends would increase from 15 percent to 22.75 percent.

Chairman TIBERI. Thank you, Mr. Sullivan, and thanks for reminding us that not everybody is for corporate tax reform. But I do want to point out my opening statement, just so you remember, that the chairman is for comprehensive tax reform for all employers and individuals, including pass-through entities and small businesses and medium-sized businesses and domestic-only businesses as well. So this is a phase in a long discussion.

With that, let me begin by asking you, Mr. Harrington, a question. In your written testimony that you provided today, you say, "Proposed corporate tax rate reduction would be good, from international tax policy standpoint." Can you elaborate more on that, and how that would be good for the U.S., U.S. economy?

Mr. HARRINGTON. Sure, Chairman Tiberi. I think part of it goes back to David's comment about the lower rate—by having a lower rate, you have less of a distortion, less of an impact of potential incentives. So, to the extent that someone is concerned about, for example, activities being moved to another place, I think having a tax rate that is more in keeping with the international norm will necessarily result in less income-shifting, just from a purely tax standpoint.

And to the extent that the tax rules are trying to reflect the economic activity, I think that result makes sense. There are consequences to being an outlier, in terms of tax rates.

Chairman TIBERI. Thank you. And if you could, all answer this question, starting with Mr. Tuerff. And we will just go down the line, ending with Mr. Harrington.

Most of the countries in the OECD have converted to a territorial system with either 100 percent or 95 percent exemption and no expense allocation. So, do you believe that the discussion draft that Chairman Camp has presented moves the U.S. international tax system within international norms? And, if so, how again is that—how is that going to benefit the U.S. economy? Mr. Tuerff.

Mr. TUERFF. Chairman Tiberi, I believe certain component pieces of the discussion draft are within international norms. Most of the other countries have a—somewhere in the range of 95 percent to 100 percent exemption system for foreign earnings. The 95 percent represents a haircut attributable to expenses that might be in the home country related to the foreign earnings. So, I think in that regard, the fundamental aspect of the dividends received deduction that has been proposed is consistent.

The subpart F rules, however, are an extension beyond the normal international norms, because they target more active income conducted outside a home country that typically is within the exemption, the territoriality exemption that is allowed. So in that respect, I would say it is beyond the typical norms of what we see in other countries.

Chairman TIBERI. Mr. Noren.

Mr. NOREN. I would agree with Mr. Tuerff. I think the proposal would bring our system into greater conformity with international norms. I think it would do a real service by substantially eliminating the lock-out effect. It would produce maybe some simplification benefits, subject to how these income shifting or anti-base erosion approaches are worked out. And I would agree that the one thing that could push us outside of international norms in an unhelpful way would be if we got too aggressive in pursuing base erosion, and started interfering with common business models, where you actually do have some significant business presence and functionality in the jurisdiction that we are talking about.

Chairman TIBERI. Thank you.

Mr. OOSTERHUIS. Yes. I agree with the other witnesses. I think, in terms of how it helps the economy, just looking at it from

my own little viewpoint of the world here as an international tax practitioner with a firm that does a lot of transactional work, first of all, the lock-out effect has the impact of incentivizing companies to use that money that is outside of the United States to spend that money outside the United States, whether it is buying other companies or building plants.

And that hurts the U.S. economy. It doesn't necessarily hurt a huge amount today, because companies can borrow cheaply in the United States today, and most of these companies are not highly levered. But over time it will increasingly be, as some have called it, an investment credit for foreign investments. And that has to hurt the U.S. economy.

The second thing that I see is the very inefficient system that we have today leads to very high compliance costs, both in terms of planning with a deferral system, and particularly planning with a foreign tax credit. The ratio of the amounts that multinationals spend on people like those of us to my right at the table, at least, and others compared to the amount of revenue we raise is very high. That is good for a few of us, but it is not good for the economy.

Chairman TIBERI. Thank you. Mr. Sullivan.

Mr. SULLIVAN. I think you have to look at the totality of—when you are making these international comparisons. It is true that the 95 percent is within the international norms. But what other countries are doing to pay for these territorial systems is increasing taxes elsewhere. They are increasing their capital gains rates, they are increasing their value-added tax rates. These are things we are not even willing to consider.

So, as long as we are within the framework of revenue neutrality, I just don't understand how we can just focus on the benefits and not look at the costs.

Chairman TIBERI. Mr. Harrington.

Mr. HARRINGTON. Thank you. Not surprisingly, I agree with the other three obvious suspects. As a general matter, I believe the participation exemption system approach in the discussion draft is within international norms. I think the 95 to 100 percent is pretty standard.

And again, I think for most OECD countries, certainly countries with economies like ours, they tend to follow a participation exemption, rather than the broader territorial approach that you might see in Latin America and some other countries.

I also agree that the subpart F rules are more stringent than you would typically see. Again, I think part goes back to the perspective issue. I think most countries think of these rules as CFC rules. You know, these are anti-deferral rules, from our perspective.

The one thing I would like to point out about base erosion is that I think you are right to be worried about base erosion in the sense that you don't want to lose what you have. But at the same time, you also have to be mindful of base erosion in the sense that you want to have a broader base because of growth and attraction of it bringing business. You can't be so focused on losing what you have that you also lose sight of creating a system that potentially makes the U.S. a better place to do business. Because then you are

not just protecting your base, you are growing your base. So you want to protect it and grow it at the same time.

Chairman TIBERI. Thank you all. I will now recognize the pride of Massachusetts, Mr. Neal.

Mr. NEAL. Thank you, Chairman Tiberi. Chairman Camp's proposal would lower the top corporate rate to 25 percent in a revenue-neutral manner. However, the proposal doesn't include details on how we would achieve the goal. As I noted in my opening statement, Chairman Camp has given us a road map without any street signs.

Dr. Sullivan, how can we achieve this 25 percent top rate goal in a revenue-neutral manner? Or, more importantly, can we lower the rate to 25 percent in a revenue-neutral manner without eliminating many of the tax incentives that benefit job creation and investment here in the United States, like the R&D tax credit? What tax expenditures would we have to consider eliminating?

And I would be happy to hear from the other witnesses after Mr. Sullivan on this question, as well.

Mr. SULLIVAN. Thank you, Mr. Neal. I take my information from the 2007 Treasury study, the Bush Administration study, which clearly shows and—that in order to get the corporate rate down to in the neighborhood of 30 percent, we would have to eliminate accelerated depreciation and expensing, eliminate the research credit, and eliminate the Section 199 deduction.

Given that those tax expenditures have strong political constituencies and do serve an important purpose, it just seems out of the question that a revenue-neutral reform could ever get anywhere near the neighborhood of 25 percent, unless—and then we have to look at international experience—we look to revenue sources outside of the corporate sector, we start thinking outside of the box.

And again, I just would mention that what we see going on in other countries is increases in value-added taxes to pay for reduced corporate taxes. We see increases in personal taxes, particularly at the high end on capital gains to pay for reductions in corporate taxes.

Mr. NEAL. Thank you. The other panelists—

Mr. OOSTERHUIS. I will add one thing. I think it is a real dilemma. And as Marty says, thinking about a new revenue source may be the best way.

You have this imperative that our tax rate is higher than other countries, and lowering it becomes important, competitively, for corporations. On the other hand, in this country we don't want the corporate tax rate to get way out of line with the highest individual tax rate, because we do not want to go back to what I remember in my father's day, when individual rates were 30 percent higher than corporate rates, and everybody did business through their own corporations to get the lower rate.

And so, there is a huge tension there that, to my mind, means we need to think about an alternative revenue source, and not allow the inefficiencies in the income tax system to continue because of our unwillingness to do that. But that is just my personal view.

Mr. NEAL. Let me follow up on that, because you raised an interesting point, Mr. Oosterhuis. The committee has heard from a

number of multinational companies during the course of this year in the hearings that we have undertaken to complain that the current U.S. worldwide tax system and high corporate rate effectively prevents them from reinvesting foreign earnings in order to create jobs, domestically.

Given your commentary on interest rates, do you think that today's low current rates on borrowing offer a credible argument?

Mr. OOSTERHUIS. It depends on the company. But I do think the problem is not as big in a low-interest rate environment as it is in other environments.

For example, take the period of time in the fall of 2008 and the spring of 2009, when companies couldn't borrow because short-term debt markets dried up. Had that continued for a substantial period of time, it could have been a real problem. And I think if interest rates go back up to more historical levels, it will be a problem.

I think as we move through time, foreign earnings build up; I mean they have built up from maybe 500 billion 7 years ago to 1.2 or 1.3 trillion now. As they build up, it gets to be worse of a problem over time.

Mr. NEAL. One of my priorities here at the committee for a long, long period of time has been to tackle the issue of low tax or no tax jurisdictions that compete with us. And it is particularly pronounced in the reinsurance industry. So I am pleased that the chairman's discussion draft included approaches for preventing erosion of the U.S. corporate tax base, which is often times critical, as we move in the direction of international tax reform.

But it is unfair, patently, for American corporations, particularly those, as you might note, are located in my constituency, or in the state of Massachusetts, to have to compete with similar companies who claim a residential address in an offshore tax haven. Now we can have an argument here about what constitutes a corporate tax system, and we can even argue about countries that compete with us that have low corporate rates. But at least they have corporate rates. It is very different than the structure that some have set up, which is for the purpose of avoiding American corporate taxes.

And I know my time has run out, but if you would—if anybody would like to give a quick answer—Mr. Chairman.

Chairman TIBERI. Anyone want to give a quick answer?

Mr. OOSTERHUIS. In a world economy, it is very difficult to design a system that doesn't have some optionality for foreign companies on whether they have income in the United States or outside the United States, whether it is through reinsurance or through interest or royalties, or whatever it is. It is just very hard to have a system that doesn't allow foreign companies to have some optionality. And that just means we need to keep our rates reasonably low.

Mr. NEAL. But the argument there is not over the idea of the corporation being a foreign corporation. The idea is that it really is an American company with a foreign address.

Mr. OOSTERHUIS. Fair enough. And that may lead to consideration of some of the rules determining residency.

Chairman TIBERI. All right—

Mr. NEAL. Thank you.

Chairman TIBERI [continuing]. The gentleman's time has expired. Thank you, Mr. Neal. Mr. Paulsen is recognized for five minutes.

Mr. PAULSEN. Thank you, Mr. Chairman. I don't think many of you touched on the component of the treatment of deferred foreign income upon the transition of the participation in this exemption system of taxation, so let me ask this.

The discussion draft talks about deeming all deferred income that is earned prior to the effective date to be repatriated, but with an 85 percent exemption. And that is payable over eight years. Do you think that this treatment is appropriate? And what issues do you see, as a part of that deeming? I mean, is this the right approach?

And you can just start off, Mr. Harrington, if you want to comment, and all the panelists.

Mr. HARRINGTON. Sure. Thank you, Mr. Paulsen. I do touch on this a little bit in my testimony on page eight. But I think the answer on this is really one of process of elimination. There really is no right answer here.

You could effectively say the participation exemption is going to apply going forward, so all the old earnings can come back exempt. I mean that has revenue issues, that has sort of, you know, effects in terms of how people would respond.

You could just simply say well, we are going to make you keep separate accounts. And I think Paul touches on this to a certain extent, the details on this, as well.

But you could just say let's have a two-track system for a long period of time. That is not really a good answer, either.

Then again, sort of by process of elimination, I think you wind up where the discussion draft is, and that is you have to have some sort of forced repatriation—it is either voluntary or it is forced. Obviously, I think people would prefer a voluntary repatriation, because there will be sympathetic instances in which someone doesn't have the cash to bring things back. And I do worry about that, particularly with respect to individuals. I think individuals are another sort of issue.

But, I mean, there are fairness issues about telling people to, you know—that you have to bring this back, particularly people that don't have the cash to do that. So I worry about it in that sort of sense. But again, I think at the end of the day it is choosing your options.

In terms of the time period, what percentage comes back, I think none of those are tax policy issues. Those are all somewhat arbitrary. Those are dealing with kind of what do you think is the fairness or unfairness of the issue. I think if it is more voluntary, you might make it less favorable. If it is compulsory, you have to make it more favorable. I think that is the tension.

Mr. PAULSEN. Mr. Tuerff.

Mr. TUERFF. I would agree with Mr. Harrington's comments in that if you have a system where you have old earnings and to try and run a two-track system with respect to the old earnings and retain the old system and have a new exemption system on a go-forward basis is far too complex, and I would not recommend that.

The difficulty then determines as to whether or not you wish to exempt old earnings. In the territorial systems adopted by Japan and the UK they exempted old earnings. Or, do you wish to go to a system whereby either elective or mandatory recognition of income of those earnings—but it needs to be done in a way that will promote and remove the lock-out with respect to those earnings, because we want the cash to be able to come back to the United States at a low cost, where it can be reinvested in the U.S. economy.

Mr. PAULSEN. Mr. Noren.

Mr. NOREN. Yes, I would agree with what my fellow witnesses have said. And in particular, I think Mr. Harrington put it just right, that it is sort of a process of elimination. You don't want the complexity of maintaining separate pre-effective date earnings accounts. While at the same time some would say it might be a wind-fall to just start applying exemption to pre-effective date earnings, wholesale. And so, I think what the discussion draft has done on the transition side is just a really great compromise of the various revenue and complexity considerations.

I would add one point. On the eight-year period, I think that is a particularly important feature, because I think what gets lost often in tax policy discussions is the distinction between earnings and cash. So we are talking about repatriation of earnings, and yet to pay tax you are going to need cash.

And so, some companies might say, "How do I repatriate a building?" To the extent that my foreign earnings were reinvested in a building, that is a little tricky to repatriate. And so I think eight years gives you some time to kind of earn out of that and deal with the liquidity issues that might be raised by this big deemed repatriation.

Mr. PAULSEN. Mr. Oosterhuis, I know time is running down, but—

Mr. OOSTERHUIS. Yes. I think we do need to deal with revenues in all of this, and from a revenue perspective, you need to do something significant. Taxing the prior earnings, or at least a portion of the prior earnings, is a good way to go.

As others have talked about, you might come up with a somewhat narrower definition of prior earnings, including earnings that are reflected in relatively liquid assets, because that is, in a sense, more fair among companies, depending on what their earnings have been used to fund.

Mr. PAULSEN. Just real quick, I know time is out.

Mr. SULLIVAN. Briefly, it is the 85 percent in the 8 years. They are arbitrary numbers, they are just about revenue.

I just would mention that if this is being used to preserve revenue neutrality in the 10-year window, it will not preserve revenue neutrality in the later years.

Chairman TIBERI. Thank you, Mr. Paulsen. Mr. Larson is recognized for five minutes.

Mr. LARSON. I thank Chairman Tiberi and Ranking Member Neal for holding today's hearing on Chairman Camp's international tax reform proposal, and I would like to thank all of our witnesses for their testimony. Tax reform provides us with a number of exiting opportunities, not the least of which is the potential to cre-

ate jobs and strengthen America's international competitiveness. That is why I think we all share the happiness to see Chairman Camp come forward with a thoughtful proposal that serves as a starting point on tax reform.

Now, not all of us will agree on every part of anyone's proposal when it comes to comprehensive reform. I still believe that we will need to examine innovative methods of taxation to ensure our Tax Code is fair and efficient for all.

I do have a couple of questions that I would like to ask, and I would like to start with Mr. Sullivan. And they are broad in their context. But Mr. Sullivan, I would be interested in getting your thoughts on how the corporate rate reduction assumed by Chairman Camps [sic] might impact research and development efforts in the United States. I have long supported simplifying and permanently extending R&D credit, and I am concerned that if we are forced to eliminate R&D credit to get to the 25 percent rate, we may reduce the amount of research and development that occurs in the U.S. Your thoughts on that?

Mr. SULLIVAN. Thank you. If we did eliminate the research and development credit, that would certainly be to the detriment of research in the United States. It would raise—that accounts for about one percentage point of the rate reduction. So, if we don't repeal the research credit, that allows—that means we have to have a corporate statutory rate, which is one percentage point higher than it otherwise would be. So, it certainly would be detrimental to U.S. research.

Mr. LARSON. The other panelists agree?

Mr. TUEFF. I think it will have a—some effect. But I would say it is only incremental effect, because research and development activities, in many cases, are centered throughout the world. The issue is what is the impact on incremental research.

I think the proposal would authorize the ability to remit funds back to further develop and increase research activities in the United States, where today a significant amount of research is currently conducted. By reducing the cost of remitting funds back to the United States, it encourages the expansion of those existing activities of research and development.

Obviously, that needs to be balanced against the fact that if a research credit is lost, that there would—may be a net impact. But I think the proposal promotes the return of funds to the United States for additional research here.

Mr. LARSON. In striving for revenue neutrality, as Mr. Camp's proposal seeks to do—and we commend him for that—it does seem to create gaps. And a number of you have alluded in your testimony about what is happening globally.

With respect to global transactions, what do you make of Europe's move towards a transaction tax? Would a transaction tax be conceivable in this country? Should a nation that consumes more than anyone else in the world look at this as striving towards getting to revenue neutrality and filling up some of the gaps that would otherwise be created?

Mr. OOSTERHUIS. Were you referring to a financial transaction tax, or a broader, value-added tax?

Mr. LARSON. A broad tax, in general, but we could start—

Mr. OOSTERHUIS. Right.

Mr. LARSON [continuing]. If you want, with a—just in a financial tax area—

Mr. OOSTERHUIS. Yes.

Mr. LARSON [continuing]. On taxes on over-the-counter drugs. There are transaction taxes that are placed already on both the commodities and on the SEC.

Mr. OOSTERHUIS. Right.

Mr. LARSON. But not on the over-the-counter, or the “dark market,” as it is referred to.

Mr. OOSTERHUIS. Yes. I really don’t have any expertise on the questions raised by a direct tax like that on a specific transactions, what does it do to the market, how mobile are the transactions to go to other markets, and how does it build inefficiencies in these markets. Marty may be better able to comment on that than I would be.

Mr. SULLIVAN. There is a lot of interest in financial transactions tax. At first blush it looks very attractive, because it is a very low rate and a very broad base. But I think it is really—operationally, would be impossible to prevent administrative problems and competitiveness problems. There are a lot of better ways of taxing financial institutions and the markets and regulating the markets than imposing that type of tax.

On a broader commodity—broad value-added tax, we economists all think it is a great idea, and we should look at it. I don’t think you will find 1 economist out of 100 that would disagree with that.

Mr. LARSON. How would you define the difference between transaction taxes in general—not just financial transactions—and a value-added tax?

Chairman TIBERI. The gentleman’s time has expired, but you can answer the question.

Mr. SULLIVAN. They have different administrative mechanisms. But economically, their effects are the same.

Chairman TIBERI. Thank you. Dr. Boustany is recognized for five minutes.

Dr. BOUSTANY. Thank you, Chairman Tiberi, for holding this really important hearing. And I want to publicly thank Chairman Camp for putting out this discussion draft in a very public way to start a real earnest discussion on what we need to do with our Tax Code to promote American competitiveness.

And gentlemen, I want to thank you. Your testimony has been very helpful. I read through most of it real carefully. And I want to focus some questions on the base erosion options that we have, and specifically option C, or the third option, which is the reduced rate of taxation for foreign intangible income. And granted, we—and this came up in some of the previous discussion and your oral comments—we have some key questions about how to attribute income to intangibles, and we have to work through that.

But if we can do that successfully, would this third option be effective in preventing our base erosion? If we can answer those key questions on the attribution of income—

Mr. NOREN. Yes, I think it would be effective. I do think that the attribution of income would be awfully tricky. And then the

question is, does it become too effective, such that it produces an excessive tax burden on U.S. companies?

It is sort of a step in the direction of current basis taxation. And certainly at a sufficiently low rate that is workable. But the concern that has been historically expressed about ideas like this is that the rate could end up increasing at some later point in time, and yet you would be stuck with this current basis taxation model. And so what might start out as being a perfectly workable system could kind of slip into something more harmful to companies. And that would be the main concern.

Dr. BOUSTANY. Other comments?

Mr. OOSTERHUIS. The one thing about it that I think is definitely worth a lot of consideration is that it differentiates between intangible income that relates to foreign sales and intangible income that relates to sales back to the United States.

And in terms of the base erosion concerns that many have articulated going forward, I think focusing on that distinction and focusing on ways to implement a differential regime is important. Because if there is base erosion, it has got to likely mostly be with respect to activities back in the United States, and not purely foreign transactions.

Dr. BOUSTANY. And to follow up on that, Mr. Oosterhuis, so this approach would address current incentives for R&D to migrate offshore?

Mr. OOSTERHUIS. Yes, it certainly would, particularly to the extent that the functions that are moved offshore are ultimately leading to transactions back in the United States, as opposed to just further exploiting foreign markets.

Mr. NOREN. Yes, and I might add on that that one difference between option C and option A is that option C does not distinguish between the origins of the IP, whereas option A, the excess returns proposal, does. And so that might be an additional benefit that C would have over A, in that it would provide less of an incentive to do R&D, for example, in one location as opposed to another.

Dr. BOUSTANY. Okay. And, Mr. Noren, in your testimony about option C, you state that a key issue will involve attributing income to IP, which would give rise to valuation and transfer pricing type analysis that is not required under present law. How would this be different? Elaborate further on that for me.

Mr. NOREN. Sure. And so present law certainly requires plenty valuation and transfer pricing analysis. But I think Mr. Tuerff perhaps put it better than I did when he said that this option can cause you to have to tease apart or sort of unscramble—

Dr. BOUSTANY. The egg—

Mr. NOREN [continuing]. The economic omelette, yes, in a way that present law doesn't require. And so that is what I had in mind.

Dr. BOUSTANY. Okay. And Mr. Tuerff, that does add a layer of complexity. And from a compliance/enforcement standpoint, could you—

Mr. TUERFF. Yes, it raises—

Dr. BOUSTANY [continuing]. Elaborate?

Mr. TUERFF. It raises a significant concern, because our current transfer pricing rules look to a given transaction, and compare that

transaction with third-party transactions, requiring documentation up front at the time of filing a return to justify the transfer price. This takes it to another level by saying you have a transaction, now we are going to start carving off the returns within that transaction to identify intangible versus non-intangible income. So it is much more complex.

Dr. BOUSTANY. Thank you. My time has expired. Thank you, Mr. Chairman.

Chairman TIBERI. Thank you, Dr. Boustany. The subcommittee is fortunate to have with us today the former chairman of the full committee, and the author of the mother of all tax reform proposals, Chairman Rangel, you are recognized.

Mr. RANGEL. Thank you so much, Mr. Chairman, and thank you so much for calling this hearing. For purposes of my questions, I have been asked an hypothetical to advise a New Yorker as to where to place his firm. He is a big manufacturer of widgets. So I would want you to stop me if I am giving the wrong advice as to the positive things that—if he decided to go to this foreign country.

One, they have a much lower corporate rate. Two, the country is prepared either to subsidize or give you the property if you want to reinvest there, because you don't—you can't send your money back home. Three, their market for widgets is actually growing, so you don't have the big problem there. The workforce is more highly trained. I mean all this stuff about Americans and high productivity, I didn't hear anyone argue against the training. I'm sorry I didn't. Climate, language, all of those things, depending on what.

Then I get a call from the President of the United States, and he says, "Whatever it is to take your client to build in the United States, that is going to be done," so I immediately rush to you guys and say, "Please give me a list of things that I can tell my client that he has to stay in New York, we need the jobs, we—that has to be."

So immediately, I would say we got to find some way to lower the corporate rates, and that is going to be difficult in terms of winners and losers with the exemption. I can't tell him to train the workers. But we can provide tax incentives. What can we do to turn around all of the positive things that I have already given to fulfill the mandate that we have got to have stamp, "Made in the USA"? Mr. Sullivan?

Mr. SULLIVAN. Thank you, Mr. Rangel. I think you are hitting the nail on the head here by asking this question. We all want jobs in the United States. How can we do that most effectively?

Certainly lowering the corporate tax rate, that helps us in the United States. That helps foreign companies come in to New York, it helps New York companies stay in New York.

We can have tax credits for research and development and for jobs. What I—

Mr. RANGEL. You mean—I'm sorry.

Mr. SULLIVAN. Go ahead.

Mr. RANGEL. You mean retain the credit was have for—

Mr. SULLIVAN. Retain the credit and strengthen it.

Mr. RANGEL. Well, I didn't tell you how I was going to reach a lower tax. That would be a problem I have to face if you tell me, you tell the President——

Mr. SULLIVAN. Right.

Mr. RANGEL [continuing]. If he wants a lower rate he has to give up R&D, I got another problem. But assuming everything is going to work the way the President wants, which is really hypothetical, but okay. Make certain that we do have an incentive for research and development, one way or the other. Okay——

Mr. SULLIVAN. And I would suggest strengthening it. But what I would not suggest is hoping for—expanding offshore tax incentives in the hope that somehow increasing employment offshore will reverberate back to increased employment back in the United States.

Mr. RANGEL. I agree.

Mr. SULLIVAN. I think it is much better to focus all of our efforts on the domestic side, which will help the foreign side, rather than the other way around.

Mr. RANGEL. I couldn't agree with you more. But how do you just always pass over education? I mean we have a part of our workforce locked up in jails, producing nothing at a tremendous cost to the taxpayer with the understanding that they will be trained to cause more expenditures. And it would seem to me, forgetting the morality of it, that business would say, "You have got to do a hell of a lot better if you got to compete against these people who start off educating their kids." And I am not talking about me. I am 81.

But it seems like the future of the country, if I have got a billion people, just educating a fraction of theirs, and I have a large segment of mine living longer, doing less, fighting technology, going to jail, being absolutely unemployable, why is business so quiet about that? Albeit that it is not a national responsibility, but to me, it is national security and economic security. How do you handle that, Mr. Sullivan? I am hiring you guys now.

Chairman TIBERI. Well, the gentleman's time has expired, but the witnesses may answer.

Mr. SULLIVAN. Thank you. What I would just strongly emphasize is that competitiveness is about everybody, not just large U.S. corporations. Of course we want them to prosper and succeed in the world. But we need—as we in the joint committee wrote in the early 1990s, competitiveness is about education, training, deregulation. All of these factors contribute. And to just focus on multinationals and use the word "competitiveness" in that context I think is misplaced.

Mr. RANGEL. Thank all of you.

Chairman TIBERI. Anybody else have a comment before we go on to our next questioner?

[No response.]

Chairman TIBERI. Mr. Marchant from Texas is recognized for five minutes.

Mr. MARCHANT. Thank you, Mr. Chairman. Before we go any further, I would kind of like to clear up an earlier discussion, and make it clear. I don't see anywhere in this draft that it con-

templates a financial transactions tax. Do any of the panelists see any suggestion of that in this draft?

Mr. HARRINGTON. No.

Mr. MARCHANT. Because I can tell you back in my district this is a—I get lots of cards and letters on the financial transactions tax, and I want to make sure that it is clear that this draft does not involve that.

My first question is many commentators and stakeholders urge the committee to adopt a territorial system with no expense disallowance. The discussion draft does not disallow expenses. Rather, it exempts 95 percent of foreign dividends using the 5 percent as a proxy for expenses incurred in the U.S. to create foreign source income. Do you agree that this is the best method to address the U.S. expenses in a territorial system? And we will just go down the line in the panel, please.

Mr. HARRINGTON. Thank you, Mr. Marchant. The short answer is yes, I agree. I think that the amount of expenses that should be—well, I mean as a theoretical matter, you should disallow expenses that are related to exempt income. But I think from a practical standpoint, you are talking about a very small amount of expenses, if any, that would fall in that category.

So, the approach taken by the discussion draft, I think, is appropriate in terms of its narrowness, in terms of expense disallowance. In terms of whether it is 95 or 96 or some other number, I think to a certain extent that is in part a revenue issue and in part is sort of a compromise between resolving disputes between people who think there should be more or less.

What I do think, though, is that you should not have some very broad set of expense allocation rules like we have currently that you would apply to this type of income. I think, one, it is too broad and I think it is complicated.

Mr. MARCHANT. Thank you. Mr. Tuerff.

Mr. TUERFF. Yes, Mr. Marchant. I would agree with Mr. Harrington, that I think the approach of taking a small percentage of the income and making it taxable is a reasonable approach, as opposed to a very detailed method of allocating specific expenses. And it is consistent with international norms. Whether it is 95 percent is the right percentage can be debated, but I think that approach is much better than the specific allocation approach.

Mr. MARCHANT. Thank you.

Mr. NOREN. I would agree that the approach makes a lot of sense. It avoids a lot of the complexity that would go with expense allocation and disallowance. I would also note that, in addition to the five percent so-called haircut on the distribution, there also is a set of thin capitalization rules applied, and I would say both the haircut, taken together with the thin cap rules, really direct two different responses to the concerns that might lead people to say that you need to allocate expenses and disallow them.

So I think the discussion draft really represents a serious effort at dealing with that issue.

Mr. OOSTERHUIS. I take a little bit different approach, although I disagree with—I do agree with the bill.

I don't see the five percent haircut—as we have been calling it, the 95 percent deduction rather than 100—as being a substitute for

what otherwise would have been the proper disallowance of expenses, because I don't think, with respect to R&D and G&A, as I mentioned in my oral statement, there should be any disallowance, no matter what the exemption is. And with respect to interest, the thin capitalization rule provides a framework for dealing with the disallowance of interest expense. And so, therefore, you don't need the haircut with respect to that expense, either.

So it is fine to have the 95 percent rather than 100, if from a revenue point of view that is what you need. But I wouldn't say you need it because we otherwise would have expenses that we would be disallowing.

Mr. SULLIVAN. I generally agree with the panel, but I think we need to be very careful. Remember, we are exempting foreign income. If we do not properly allocate expense, or have a proxy for that allocation, that means we are not only exempting foreign income entirely from tax, we are subsidizing foreign income. So we are driving the effective rate of tax below zero. So, we want to be careful about that.

Having said that, it is extremely complicated to get these rules to work. And they need to be judged in conjunction with the thin capitalization rules. It is how—it is—the whole entire package has to be judged, and not just one—this one feature alone.

Mr. LARSON. Will the gentleman from Texas yield?

Chairman TIBERI. He has about two seconds.

Mr. LARSON. It will be less than 10 seconds. Because you mentioned about the no transaction tax anywhere in the draft. Can you tell me where in the chairman's proposal the table is showing his proposal to be revenue-neutral?

I brought it up because I think we have to demonstrate how we can get to that 25 percent.

Mr. MARCHANT. I yield my time back, Mr. Chairman.

Chairman TIBERI. Thank you, Mr. Marchant. The gentleman from Pennsylvania, Mr. Gerlach, is recognized for five minutes.

Mr. GERLACH. Thank you, Mr. Chairman. Mr. Sullivan, I am looking at your October 17th op ed or article to "Tax Notes." And you make a very clear point. In fact, I will quote. "On rare occasions when Congress gets serious about reform, it gives priority to the individual income and corporate taxes. Taxation of small business and pass-through income is neither here nor there."

And you go on to then talk about some strategies and efforts we ought to undertake, as Congress, to deal with small business pass-throughs relative to overall tax reform.

Recognizing that the chairman's draft focuses on the issue of territorial versus a worldwide system of taxation, I would like to have your thought on the issue of comprehensive tax reform, whether it should be done comprehensively at one time, so as to avoid or help minimize any adverse impacts that would occur within the economy domestically, or whether a phasing of that reform—i.e. doing a territorial piece of legislation first, then coming back, doing a—say a small business pass-through piece of legislation—and this is also for the other panelists—does it really matter, one way or the other, how we phase? Or, from a flip side, a more comprehensive approach to doing tax reform, relative to what the impacts would be, positive or negative, on our economy?

Mr. SULLIVAN. Thank you very much for the question, Mr. Gerlach. The—because I live such an exciting lifestyle, I think about these things a lot. And I have tried to compartmentalize just a simple topic of corporate tax reform by itself, which—of course it is a very complicated topic, but it can't be compartmentalized. It has got to be closely—the revenues have to balance out, and then there are the interactions on the rates.

And then, on the specific issues of small business, you know, it is just amazing to me that we have these incredibly complex rules for small businesses. They have to choose between sub-S partnerships, sole proprietorships, or even—some of them, many of them, millions of them, because sub-chapter C corporations. This is a crazy mish-mash.

We could do a great deal for the competitiveness of small businesses without spending any revenue by just taking this ridiculously complex system and simplifying it. And the reason why I said it is not—it is just not getting any attention. Nobody is thinking about this. And I think, you know, part of it is that multinationals have more people and more resources and get more attention on Capitol Hill.

But the problems that—the complexity issues that small businesses face are, per dollar of sales, are much greater and they deserve more attention.

Mr. GERLACH. We are having a lot of those discussions within our committee. I know Chairman Camp is very much aware of that issue, as well. So it is not an issue that we are not thinking about and talking about. But I am just curious as to whether, when you step out with tax reform on the business side, either corporate or pass-through, does it matter if you do it all at one time, or whether you do it in a sequencing process, starting with a territorial approach first, and then moving on to other aspects—

Mr. SULLIVAN. I will briefly say I think it has to be done all together, absolutely.

Mr. OOSTERHUIS. Yes, I would agree with that because how the territorial system is designed depends on what the corporate rate is. And then, what the corporate rate is, really, you have to start thinking about the impact of that reduction, if it is a reduction in the corporate rate, on incorporated businesses. And so, once you start broadening your framework to think about unincorporated businesses, you are really talking about the whole system.

Mr. NOREN. I would agree that the whole tax reform package ought to be pursued at one time, because the different areas do interact with each other technically. And as well, the Congress should want to keep track of what it is doing to the overall tax mix of the country, and how much are we raising from different areas.

That being said, I would say that it makes a whole lot of sense to have released this discussion draft on this particularly complex part of tax reform to get the community started looking at it now, even if it needs to be ultimately pursued together with a broader package.

Mr. TUEFF. I would also agree if the objective is to reduce the cost of repatriation of earnings back to the United States for reinvestment in the U.S. Then the tax rate is going to be critical in that determination. So I think doing a territoriality system in con-

junction with addressing a corporate tax rate is an important element that needs to be considered together.

Mr. GERLACH. Thank you.

Mr. HARRINGTON. Just briefly, I agree that ideally you do want to try to do all the reforms together. I mean it is a lot like the pushing down on the tube of toothpaste, it is going to pop up somewhere else.

But at the same time, I think one has to be mindful that each of these component parts are very difficult by themselves. And putting them together makes it also hard, as well. So, if it turns out that you are unable to do the broader reform, but you have pieces, then I think you might have to go that way, just because they shouldn't be held hostage.

But I think it is difficult to get consensus on particular items without knowing how they fit in the bigger picture.

Mr. GERLACH. Thank you. Thank you, Chairman.

Chairman TIBERI. Chairman Camp will be pleased with your response on that last question. With that, I will recognize the gentleman from Wisconsin, Mr. Kind.

Mr. KIND. Thank you, Mr. Chairman. Mr. Chairman, I am pleased with that response, because I think it is the right approach to comprehensive tax reform. I don't think we should just be limited to the C side, but also the pass-through, given the fact that the majority of businesses operating in this country are pass-through entities to begin with. So, if we are going to do this, I think we got to do it together, do it in a way that doesn't discriminate or set up this disparity between C corporation versus S and limited and everyone else.

But let me—Mr. Sullivan, let me start with you. And I have been trying to figure out—and I have been the one kind of thinking aloud here on the committee for quite some time—that if the overall goal is to simplify lower rates, try to make us more competitive, and the goal is 25 percent, we would have to eliminate all of the expenditures on the corporation side in order to achieve that. And how you pay for that is going to make a big difference.

But by eliminating 199, accelerated depreciation R&D, the impact on the manufacturers of this country would be impacted. Do you see it that way, too? If you are eliminating that while still lowering rates to a goal of 25 percent?

Mr. SULLIVAN. That is just the way the numbers come out. Manufacturers are research intensive. Manufacturers are capital intensive. And obviously, manufacturers benefit from the manufacturing deduction. So we have put into place tax rules with good intentions—and they are good intentions—to help manufacturing. And if we lower the rate and get rid of those, we are going to hurt the manufacturing sector.

Mr. KIND. Well, let me ask you this on that same line. There is a lot of feedback, 199, very complicated, the compliance and the justification thing, and all that. It is too cumbersome.

So, what is wrong with the simple proposition that if your business operating in the United States, and if you are making something, you are inventing something, creating something, building something, growing something, you are going to get a major tax advantage for doing that right here in the United States of America,

and get rid of 199 and structure a different provision that rewards that type of activity here in this country, creating those type of jobs right here?

Mr. SULLIVAN. I absolutely—Section 199 is needlessly ridiculously complex for the simple thing that it is trying to achieve. It would be much better to get rid of it and lower the rate.

Mr. KIND. Yes.

Mr. SULLIVAN. And—

Mr. KIND. Let me ask everyone on the panel here, and—because, obviously, we are going to be wrestling with the how do we pay for this in a deficit-neutral fashion. That is—unless we are willing to dip in to the individual side to get down to 25, which will not be popular at all, I think we are going to have to be a little more creative in thinking out of the box.

And for the life of me, I don't understand. With all the zeal to go to a territorial system, the fact that virtually every country that has it has other supplemental forms of revenue—and shall I dare say it, the VAT—and yet all the multinationals are already living in the world of VAT, so they are already complying with that, and it is not going to be a new burden or a new added complexity in their life.

So if we want to try to lower rates, why aren't we seriously considering, you know, moving towards a VAT system in order to supplement that lost revenue that we would otherwise see going to 25?

Mr. SULLIVAN. May I?

Mr. KIND. Yes, go ahead.

Mr. SULLIVAN. I think any economist would say we are glad to get rid of the corporate tax and replace it with a value-added tax.

I also think it is important to point out that in the 1980s there were lots of Republicans advocating replacing the corporate tax with a value-added tax. And for some reason that has gone off the radar now. And I think it is—may not be politically attractive, but economically it makes a heck of a lot of sense.

Mr. OOSTERHUIS. You know, when you stand back and look at the difficult issues we are talking about, it really does take you in that direction. Because inherently in an income tax, an income tax taxes where you perform an activity. And given how mobile activities are in a global economy, that means countries have to compete for those activities, and tax rates is an element of that competition.

A value-added tax doesn't work that way. A value-added tax taxes where the person who buys the good is located. And that doesn't move. People aren't going to move from Wisconsin to Dublin to pay a lower value-added tax. And so whether you manufacture the good in Japan or in Singapore or in the United States, the tax is the same.

And so, that tax, from an international location of activities perspective, is much more rational than an income tax. And that means you have to be careful how much pressure you are putting on the income tax, in terms of how much of the revenue that you have to raise—you are raising revenue through a tax where that inevitable mobility of activities is an important factor.

Mr. KIND. Mr. Oosterhuis, let me stay with you just for a second. I mean you are familiar with the substance of what this committee works on. Anything that jumps out at you that gives you

pause or concern about the proposed draft that the chairman has released so far? Any—

Mr. OOSTERHUIS. No. I think, as a framework for the discussions of what is the right type of territorial system to have—and we really do need to move to a territorial system—

Mr. KIND. Well, I would love to follow up with you on sections 904, 909 in particular—

Mr. OOSTERHUIS. Sure.

Mr. KIND [continuing]. Some of the concerns being raised with that.

Mr. OOSTERHUIS. Happy to do that.

Chairman TIBERI. The gentleman's time has expired. With that, the gentleman from North Dakota is recognized for five minutes. Mr. Berg.

Mr. BERG. Thank you, Mr. Chairman. I want to thank the panel for being here. I apologize, we had some severe flooding issues in North Dakota, and I was in a meeting with FEMA, still trying to correct some of that.

The number-one issue we are faced with here is how do we get our economy going, how do we create jobs. And so, clearly, one of the things that this committee has done has spent a lot of time on our international tax law, and is there a way that we can, again, create a more fair, simpler, more streamlined system that would encourage more capital being reinvested, preferably here in America, which, you know, brings us to territorial system.

So, at the same time, I am learning that things don't move very quickly here. And, you know, I understand the merits and rationale for an overall reform package. I mean, obviously, if we deal with corporate, that impacts all the small businesses that aren't incorporated but operate as a partnership, those that are both in the country and out of the country.

I guess my question for you—and I hope the chairman doesn't hear this—but if we could only—if our focus was simply to try and streamline this one component quickly to try and bring more capital back into the United States, is that possible? Mr. Harrington, you kind of touched on that in your last answer.

Or, I mean, would that be an option? How—any advice on—

Mr. HARRINGTON. Well, if the chairman isn't going to hear your question, is he going to hear our answers?

Mr. BERG. No, no.

Mr. HARRINGTON. Okay.

Mr. BERG. We will expunge all that.

Mr. HARRINGTON. Okay. The short answer, I think, is yes. You could do this as a discreet piece. I mean I think you could do, you know, a participation exemption replacing these sets of rules. You could do that. I think you couldn't do it as well as you could if you did it as part of a broader issue, because I think, again, some of these issues, how, from a practical standpoint, the rate is going to matter.

Mr. BERG. Yes.

Mr. HARRINGTON. Like I said, I would look at some of these differently, if it is a 25 percent rate—wanting to know how do you treat individuals, what is going on with pass-through entities, I think those would be significant enough. I think they would—I

can't call them barriers, but they would be significant obstacles to doing this alone, but it is possible to do it on its own, I believe.

Mr. BERG. Well, and certainly the challenge would be if we made this change, and then businesses made decisions based on the tax policy before we could get the rest of the components changed and in place. Therein might lie the bigger challenge.

Mr. HARRINGTON. And effectively, you are doing part one, and then you would have to have a part two that followed up. So you would have to know there would be issues.

Mr. BERG. And we don't need to go through that, unless anyone had any specific things that you would like to address on that.

I had another question I would like to talk in relation to the base erosion and, you know, just really, if we move the territorial system, how do we prevent that from happening. And in the draft there are a couple things that deal with the thin capitalization rule, as well as other options to prevent this base erosion.

And I am just wondering. Are there other base erosion rules that you believe the committee should consider, in addition to those that are in place? I would like to address that to the whole panel.

Mr. OOSTERHUIS. I will start out. I think there are. I think people are just beginning to think about it. We, as a tax community, haven't done a lot of thinking about reforming subpart F more broadly, including dealing with base erosion, and we need to start thinking about it. And that is one of the important things that the bill does; it sets the table for everybody to give it concentrated thought.

I do think one thing would be helpful for us. The revenue estimators in scoring a territorial system have perceived that there is going to be a substantial erosion that occurs under a territorial system that is not occurring today. We need to understand that better, because if we are going to talk about base erosion reforms to subpart F, that is the income that ought to be targeted first.

And I don't quite, on my own, understand where they see that much base erosion coming from, to be honest. But if it is there, then we need to understand what it is so we can think about redesigning subpart F to minimize the chances of that income, which today is being taxed in the United States, being eligible for exemption.

Mr. NOREN. Yes. In terms of other options, I think, as I laid out in some of my written testimony, I think there are modifications that you could make to all of the different options, and particularly to accommodate structures where you have significant functionality in the CFC's location.

Another point I would make is that this could be an opportunity to really accomplish a comprehensive reform of subpart F. And so, rather than just focusing on adding further restrictions, and thus, further complexity, you know, if we decide that there is a better way to balance concerns over income shifting and other concerns about competitiveness and so forth, maybe we could eliminate some of the existing categories of subpart F income, and then replace them with the better new idea that we come up with.

The final thought that I had is that you could also reduce the incentive for income shifting somewhat by administering the proposal's five percent haircut on a current basis, rather than allowing

that piece to be deferred. And so that might be another small step to take to reduce some of the income-shifting incentives without creating a lot of additional complexity.

Chairman TIBERI. Well, the gentleman's time has expired, but anybody else want to answer the question?

Mr. TUERFF. I would just agree with the comment that in looking at base erosion I think the focal point should be on the active business operations that are conducted offshore, and that those should be allowed to be conducted, consistent with other norms that are applied in other countries.

Chairman TIBERI. Anyone else? Well, thank you. Thank you, Mr. Berg.

That concludes today's hearing. Please be advised that Members may submit written questions to the witnesses. The questions and the witnesses' answers will be made part of the record for today's hearing.

I want to thank the five of you for your participation today. It was very, very helpful, very educational. I believe it helps us move forward on this debate of comprehensive tax reform, specifically with respect to the international tax piece, and will help us as we continue to try to move a bill on comprehensive tax reform.

Thanks so much. The hearing is adjourned.

[Whereupon, at 11:35 a.m., the subcommittee was adjourned.]

MEMBER QUESTIONS FOR THE RECORD

**Questions for the Record for Rep. Richard Neal
W&M SRM Hearing on Camp Territorial Proposal
November 17, 2011
John L. Harrington**

Question:

The Camp territorial proposal retains current law subpart F, which taxes U.S. shareholders of foreign corporations on their share of certain types of income earned by the foreign corporation, even though the income has not been repatriated. Current law (section 961) permits U.S. shareholders to increase the tax basis of their stock by the amount of the Subpart F inclusions. This adjustment prevents double taxation of the subpart F income that would occur if the shareholder recognizes a gain upon a future sale of the stock.

The Camp proposal would repeal the basis increase. This would adversely affect U.S. companies that have paid tax as a result of Subpart F inclusions and would pay tax again upon any gain realized from a future sale of their stock. Do you see this as an issue? If so, how would you address it?

Answer:


To the extent that a shareholder has been taxed on the undistributed income of a foreign corporation, the conceptually right answer is to permit a tax-free distribution of the previously taxed income or to increase basis in the foreign corporation stock to reflect the previously taxed earnings so that the earnings are not taxed twice. New Code section 1247, which would be added by section 302 of the Ways and Means Committee Discussion Draft, provides a [95] percent exemption for gains on the sale of stock in qualified foreign corporations. In the case of “active” foreign corporations, the proposed repeal of section 961 is not particularly significant since [95] percent of the gain would not be taxed. So, although the amount of gain would be overstated in those cases, Congress must weigh the simplification arising from repeal of section 961 with the fact that [5%] of gain would be overstated. From a “rough justice” standpoint, how this and analogous issues are resolved should be reflected in the ultimate rate chosen for the exemption. On the other hand, there are some shareholders in foreign corporations that are not eligible for the [95] percent exemption on sale of their stock but that may be subject to subpart F. These include not just shareholders in foreign corporations that fail to meet the “active” test of section 1247 but also those who are individuals and are not eligible for the [95] percent exemption. For sales of stock in those corporations, failure to allow a basis adjustment such as that in current Code section 961 would overstate gain in those shares. Accordingly, retention of section 961 for sales of stock that are not eligible for the [95] percent is desirable and should be considered by the Committee in the next iteration of the proposal.

Question:

Would transition rules mitigate the negative impacts (outbound transfers, branch loss recaptures) of treating foreign partnerships and branches as CFCs? How would you craft such transition rules? There is a concern by some companies that the Camp proposal would accelerate tax.

Answer:

Transition rules would mitigate some of the short-term impacts of treating foreign partnerships and branches as CFCs. However, some of these issues, such as the consequences of inadvertent CFC terminations as a result of business ebb and flow that I described in my written testimony, are ongoing and therefore must be addressed in the substantive tax rules. I believe that the transition rules should focus on the goal of assisting taxpayers as they move from the old system to the new system. So, for companies that determine that they should change their business form in light of the new rules, transition rules should facilitate those changes. Thus, transition rules that provide a temporary break from the outbound transfer and branch recapture rules are appropriate in order to effectuate the policies Congress intends in the new system. To the extent that problems will arise on an ongoing basis, however, transition rules are not sufficient. If there are problems in the new system, those have to be addressed in the permanent rules, not in the transition rules.



Responses of David G. Noren to

Rep. Richard Neal's Questions for the Record

November 2011 Select Revenue Measures Subcommittee Hearing on the Ways and Means Committee's International Tax Reform Discussion Draft

Rep. Neal's questions:

The Camp territorial proposal retains current law subpart F, which taxes U.S. shareholders of foreign corporations on their share of certain types of income earned by the foreign corporation, even though the income has not been repatriated. Current law (section 961) permits U.S. shareholders to increase the tax basis of their stock by the amount of the Subpart F inclusions. This adjustment prevents double taxation of the subpart F income that would occur if the shareholder recognizes a gain upon a future sale of the stock.

The Camp proposal would repeal the basis increase. This would adversely affect U.S. companies that have paid tax as a result of Subpart F inclusions and would pay tax again upon any gain realized from a future sale of their stock. Do you see this as an issue? If so, how would you address it?

Would transition rules mitigate the negative impacts (outbound transfers, branch loss recaptures) of treating foreign partnerships and branches as CFCs? How would you craft such transition rules? There is a concern by some companies that the Camp proposal would accelerate tax.

David Noren's responses:

I do see the proposed repeal of both the "previously taxed earnings" rules of section 959 and the related basis adjustment rules of section 961 as an issue. Repealing these rules would effectively cause subpart F income to be taxed more heavily than purely domestic income, which I do not think is warranted. I would recommend preserving both sets of rules under a territorial dividend exemption system.¹

Regarding the proposal to treat first-tier foreign branches and (under regulatory authority) certain foreign partnerships as CFCs, assuming that such a proposal is enacted, I do think that special transition rules would be needed to mitigate "negative impacts" of the kind that Rep. Neal describes. I would recommend transition rules that would provide that the conversion of a branch (or partnership) into a deemed CFC would not give rise to a taxable outbound transfer of any property that was held or used by the branch or partnership prior to the introduction of the new system. Such an approach would mitigate the transition impact of introducing the deemed-CFC rules, without undermining the purposes of those proposed rules (assuming the rules are needed in the first place).

¹ See David G. Noren, "The Ways and Means Committee International Tax Reform Discussion Draft: Key Design Issues," 41 Tax Mgmt. Int'l J. (BNA) 167, 175-76 (April 2012).

**Questions for the Record for Rep. Richard Neal
W&M SRM Hearing on Camp Territorial Proposal
November 17, 2011**

1. The Camp territorial proposal retains current law subpart F, which taxes U.S. shareholders of foreign corporations on their share of certain types of income earned by the foreign corporation, even though the income has not been repatriated. Current law (section 961) permits U.S. shareholders to increase the tax basis of their stock by the amount of the Subpart F inclusions. This adjustment prevents double taxation of the subpart F income that would occur if the shareholder recognizes a gain upon a future sale of the stock.

The Camp proposal would repeal the basis increase. This would adversely affect U.S. companies that have paid tax as a result of Subpart F inclusions and would pay tax again upon any gain realized from a future sale of their stock. Do you see this as an issue? If so, how would you address it?

Response

Under section 302 of the Discussion Draft, where a domestic corporation that is a 10% shareholder of a “qualified foreign corporation” sells or exchanges stock in the foreign corporation, 95% of any gain realized on the sale or exchange is excluded from income. In other words, gain from the sale or exchange of stock of a foreign subsidiary is appropriately treated in the same manner as dividends paid by a foreign subsidiary (i.e., 95% of such gain is excluded from income just as 95% of any dividend paid by a CFC is deductible).

The Discussion Draft’s elimination of section 961’s basis step-up for subpart F inclusions does result in the double taxation of gain that is attributable to retained earnings that were previously taxed under subpart F. Such earnings are subject to full U.S. tax when earned. If the earnings are retained by the CFC, the gain attributable to those retained earnings is then effectively subject to an additional 1.25% upon the sale of the stock (assuming a tax rate of 25% and the application of the 95% DRD). However that double taxation of gain attributable to retained subpart F income parallels the double taxation of subpart F income generally under the Discussion Draft. The Discussion Draft eliminates section 959 and thereby eliminates the exclusion for dividends of previously taxed income. As a result, under the Discussion Draft, previously taxed subpart F income is subject to an additional 1.25% tax upon actual repatriation. Given the elimination of section 959, and the resulting double taxation of subpart F income upon repatriation, it is appropriate for the Discussion Draft to eliminate section 961 to ensure parallel treatment for gain from the sale of stock that is attributable to retained subpart F income.

The Discussion Draft also attempts, appropriately in my view, to ensure that gain from the sale of stock in a CFC which owns assets that generate subpart F income does not escape U.S. taxation. However, the manner in which it does so creates a “cliff effect” that can lead to inappropriate results. To qualify for the 95% exemption on the sale of CFC stock, at least 70% of the CFC’s assets must be active assets at the time of the sale and over the preceding three-year period. This 70% rule creates a cliff effect whereby *all* gain from the sale of stock of a CFC that

satisfies the test is entitled to the 95% exemption, while a CFC with just under 70% active assets does not qualify, and all the gain from the sale of its stock would be subject to full U.S. taxation.

As I suggested in my previous testimony, an alternative approach that would avoid this cliff effect would treat the sale of the stock of a CFC as an asset sale in an approach akin to a mandatory 338(g) election. Gain attributable to retained earnings would be deemed distributed and entitled to the 95% DRD, gain attributable to active assets would be eligible for the 95% exclusion and gain attributable to passive assets would be subject to full U.S. taxation. The taxation of the sale of CFC stock would thus parallel the treatment of earnings of a CFC, while avoiding the over- and under-inclusiveness of the 70% active asset test currently included in the Discussion Draft. If such an approach were adopted, any previously taxed subpart F income would be part of the retained earnings that would be deemed distributed so no basis adjustment with respect to the subpart F income would be required.

2. Would transition rules mitigate the negative impacts (outbound transfers, branch loss recaptures) of treating foreign partnerships and branches as CFCs? How would you craft such transition rules? There is a concern by some companies that the Camp proposal would accelerate tax.

Response

As a general matter, I support the Discussion Draft's approach to treating foreign branches and partnerships as corporations to ensure consistent treatment across foreign operations. For those U.S. multinationals that currently operate through a foreign branch, that deemed incorporation can result in taxation – either under section 367(a) or 367(d) – as a result of the deemed outbound transfer of assets. This can lead to double taxation without adequate foreign tax credit relief. However, the problem is caused by the overly broad scope of section 367(a) and (d) as currently in effect and not in the treatment of branches as deemed corporations under the Camp bill.

The problem is that while section 367(a) excludes most tangible assets that are part of a foreign branch (in the sense that they constitute an active foreign trade or business), and while section 367(d) excludes foreign goodwill, which is often a branch asset, neither provision has a blanket exclusion for foreign branch assets. Thus, for example, a U.S. corporation that sells inventory through a U.S. branch triggers U.S. tax on that inventory when it incorporates in the foreign jurisdiction whereas the foreign country (if its rules parallel U.S. rules) will only tax that inventory when it is sold. This mismatch can result in double taxation. Similarly, and more importantly as a practical matter, if a U.S. corporation uses a trademark (or other intangible property other than foreign goodwill) in connection with a foreign branch and then incorporates that branch, the transfer of the trademark (or other intangible property) will give rise to an annual charge under section 367(d). Yet it is unlikely the foreign country would give a deduction for any deemed or actual royalty for that trademark (or other intangible property) assuming that the

costs of developing that trademark (or other intangible property) was borne by the branch in prior years.¹

These examples illustrate the broader defect in Section 367(a) and (d): to the extent it triggers taxation on the outbound transfer of assets it should exclude assets the costs of which were borne by a foreign branch. Rather the provisions should apply if and only if there is a transfer of assets to the branch by its U.S. corporate owner. For the future, such a rule will in effect become the law if the Camp proposal of treating branches as foreign corporations is enacted. But the enactment of the proposal does create a transition problem given the current defects in sections 367(a) and (d) as applied to foreign branches. Thus, a transition rule that excludes from those provisions assets the costs of which have been borne by a branch as part of its branch business makes sense.²

¹ Whether costs were "borne" by the branch can be determined by whether such costs were deducted by the branch for both local income tax and U.S. income tax purposes.

² An anti-stuffing rule may be necessary to prevent the transfer of assets to the branch in anticipation of the legislation.

PUBLIC SUBMISSIONS FOR THE RECORD



**Statement of Business Roundtable for the Record
of the House Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Hearing on International Tax Reform Discussion Draft,
November 17, 2011**

**The Honorable John M. Engler
President, Business Roundtable**

Business Roundtable welcomes this hearing on the Ways and Means international discussion draft as part of the Committee's broader objective of comprehensive corporate and individual tax reform.

Business Roundtable (BRT) is an association of chief executive officers of leading U.S. companies with over \$6 trillion in annual revenues and more than 14 million employees. BRT member companies comprise nearly a third of the total value of the U.S. stock market and invest more than \$150 billion annually in research and development -- nearly half of all private U.S. R&D spending. Our companies pay \$163 billion in dividends to shareholders. BRT companies give nearly \$9 billion a year in combined charitable contributions.

Business Roundtable commends Chairman Camp for his leadership in putting forth a detailed corporate tax reform proposal to address many of the deficiencies of the current tax system in order to provide for a stronger domestic economy with increased investment, increased employment, and growing wages. The proposal provides the essential components to a reformed corporate tax system, including a commitment to a significantly lower statutory rate and a territorial tax system.

Reform of the U.S. corporate tax system and its treatment of international income are of significant importance to the growth of the U.S. economy. U.S.-headquartered companies with operations both in the United States and abroad directly employ 23 million American workers and they create over 40 million additional American jobs through their supply chain and the spending by their employees and their suppliers. The ability of American companies to be competitive in both domestic and foreign markets is essential to improving economic growth in the United States, reducing high rates of U.S. unemployment, and providing for rising American living standards.

The U.S. corporate income tax system today is an outlier relative to the tax systems of our trading partners at a time when capital is more mobile and the world's economies are more interconnected than at any time in history.

The combined U.S. federal and state statutory corporate tax rate is the second highest in the OECD, and will soon be the highest rate following anticipated reforms in Japan in 2012. A significant reduction in the statutory corporate tax rate is an essential element of meaningful corporate tax reform.

The United States is also the only G-7 country that taxes the worldwide income of its corporations, with Japan and the United Kingdom having adopted territorial tax systems in 2009. Within the OECD, 26 of the other 33 countries use territorial systems for the taxation of foreign earnings.

Under territorial systems, a domestically headquartered company pays the same rate of tax on its active foreign earnings as do other companies operating in the foreign jurisdiction but it owes no additional tax when it brings back foreign earnings for reinvestment in its home country. In contrast, under worldwide tax systems, the domestically headquartered company owes additional tax to its home country on dividends of foreign earnings if the domestic rate of tax exceeds the foreign tax rate on its foreign earnings. High tax rate countries that use a worldwide system subject the foreign earnings of their domestically incorporated multinational corporations to tax from two taxing jurisdictions.

The combined effect of the high rate of U.S. corporate tax and the worldwide U.S. tax system makes it more difficult for U.S.-headquartered companies to compete effectively in foreign markets, reduces the reinvestment of overseas earnings back into the United States, and discourages new investment in the United States by both U.S.- and foreign-headquartered companies.

Since the time of the last major reform of the U.S. corporate tax system in 1986, the world's economies have become increasingly integrated. The importance of cross-border trade and investment has grown significantly, with worldwide cross-border investment rising six-times faster than world output since the 1980s. Today, the U.S. corporate tax system hinders the ability of U.S. companies to grow and compete in the world economy with the consequence of less investment in the United States and a more slowly growing economy with fewer job opportunities for American workers. The ability of American companies to compete and invest abroad is vital for opening foreign markets to U.S.-produced goods and expanding the scope of investments in R&D and other activities in the United States.

The discussion draft released by the Ways and Means Committee on October 26, 2011, represents a significant step towards modernizing the U.S. corporate income tax system. Below are Business Roundtable's comments on the major elements of the Committee's discussion draft.

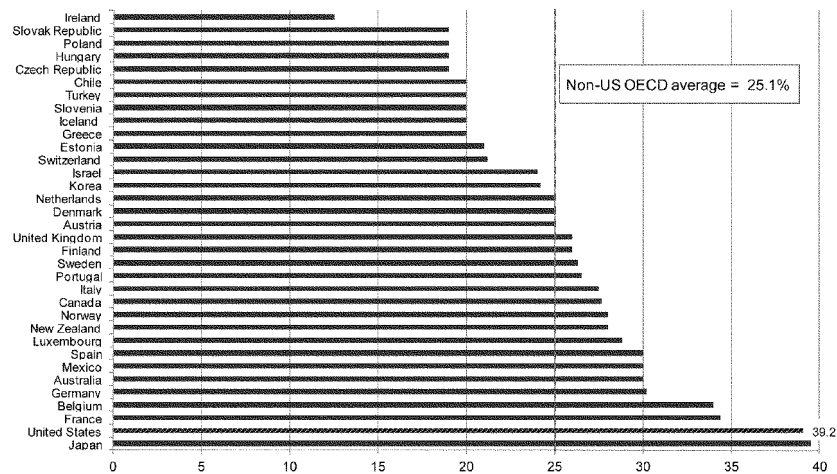
1. 25% Statutory Corporate Tax Rate

The discussion draft proposes a 25 percent federal statutory corporate tax rate, beginning in 2013, a 10 percentage point reduction from the current 35 percent rate. By bringing the U.S. rate much closer to that of our major trading partners, the reduction in the statutory corporate tax rate on its own would significantly increase the attractiveness of the United States as a location for new investment and for earning income for both U.S.- and foreign-headquartered companies.

Rate reduction can also reduce distortions that arise under an income tax, including reducing variations in effective tax rates across alternative investments and reducing the tax incentive for the use of debt relative to equity financing.

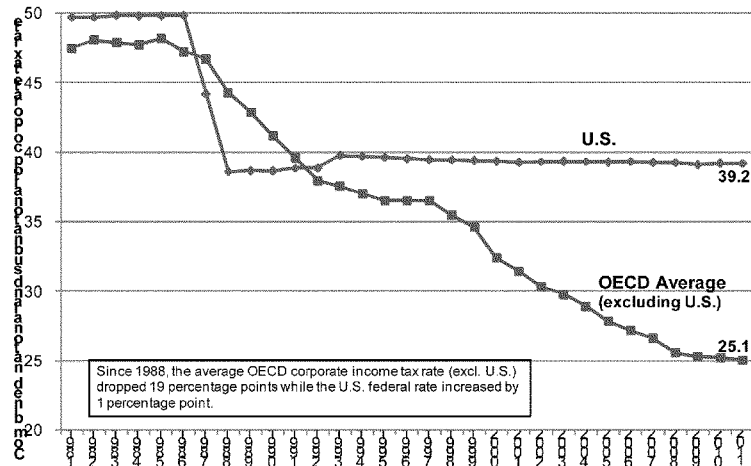
Including federal and state income taxes, the U.S. statutory tax rate of 39.2 percent is the second highest in the OECD in 2011 (see Figure 1). Based on OECD data, had the 25 percent federal rate been in effect in 2011, the combined U.S. federal and state tax rate would have been 29.8 percent, and would have resulted in the United States having the eighth highest statutory tax rate in the 34 country OECD. The average combined statutory tax rate in the rest of the OECD in 2011 is 25.1 percent. The average OECD corporate tax rate has fallen by more than 10 percentage points since 1998 and by more than 19 percentage points since 1988 (see Figure 2).

Figure 1.—OECD Combined National and Sub-National Statutory Corporate Tax Rates, 2011



Source: OECD Tax Database and PwC Worldwide Tax Summaries, <http://www.pwc.com/gx/en/worldwide-tax-summaries/index.jhtml>, and Note: Estonia tax rate shown for distributed income (retained income is exempt).

Figure 2.—U.S. and Average OECD Corporate Tax Rates, 1981-2011



Source: OECD tax database. The U.S. rate is based on the 35 percent federal tax rate and average state taxes of 6.44 percent, which are deductible from federal taxes.

Although not as widely noted as the high statutory corporate tax rate, the United States also has a high effective tax rate on corporate income. A study of financial statement effective tax rates for the 2,000 largest companies in the world found that U.S.-headquartered companies faced a higher worldwide effective tax rate than their counterparts headquartered in 53 of 58 foreign countries over the 2006-2009 period.¹

The summary materials released by the Ways and Means Committee in conjunction with the discussion draft state that the statutory rate reduction is intended to be undertaken with other reforms to provide for revenue neutrality. Business Roundtable supports the need to undertake tax reform within an overall environment of fiscal consolidation, including spending cuts that will reduce projected future deficits. When considering the revenue effects of tax reform, however, it is important to take account of the revenue feedback effects from a more competitive corporate sector and faster growing economy. The best way for the government to increase tax collections is through economic growth, not higher tax rates. Further, while base broadening measures may include the repeal of provisions that no longer serve their intended purposes, it should be recognized that some tax expenditures or other preferences serve an important role in increasing investment.

¹ "Global Effective Tax Rates," April 14, 2011, available at <http://businessroundtable.org/studies-and-reports/global-effective-tax-rates>.

Nevertheless, a reformed tax system -- with significantly lower statutory corporate tax rates, a stable tax code, and greater neutrality across alternative investments -- can result in greater economic growth and greater job opportunities for American workers.

2. Establishing a 95% Dividend Exemption ("Territorial") System

The discussion draft proposes a territorial tax system under which 95 percent of active foreign-source dividends paid by controlled foreign corporations to 10-percent or greater U.S. C-corporation shareholders effectively would be exempt from U.S. taxation, provided the specified one-year holding period requirement is met, effective in 2013. At the proposed 25 percent statutory corporate tax rate, the 95 percent exemption would result in a tax rate of 1.25 percent on foreign dividends.

The discussion draft provides an important starting point for the move to a territorial system for the United States. The proposed territorial tax system, however, is built around many existing U.S. international rules and there are many details in the proposal itself that require close examination. This is a complex area and it is critical to the international competitiveness of many U.S. companies that it be done right. We commend Chairman Camp, Chairman Tiberi, and the other members of this committee for seeking input from taxpayers, scholars, practitioners, and the public at large on the discussion draft. This submission provides our initial comments on major features of the proposed system, but our member companies will continue to examine the legislation and we intend to provide more detailed comments on other aspects of the proposal soon.

A territorial tax system structured similarly to the territorial tax systems of other OECD countries is essential for U.S.-headquartered companies to be competitive in foreign markets and have the same ability to reinvest foreign earnings at home as their competitors.

It is the experience of our CEOs that expansion of U.S. companies abroad into foreign markets increases employment at home and exports of U.S. produced goods and services into the foreign market.² A properly designed territorial tax system would increase the competitiveness of American companies in foreign markets and make U.S. companies stronger at home.

As shown in Figure 3, 26 of the 34 OECD countries use territorial tax systems, with 18 of these countries providing a 100 percent exemption for foreign-source dividends. The lowest exemption is 95 percent, used by seven OECD countries. The 95 percent exemption typically results in a tax rate of 1 to 2 percent on the foreign dividends in these countries (e.g., in Germany, 5 percent of the dividend is subject to a 30 percent tax rate, resulting in a tax equal

² This finding is also supported in economic research. One study finds that a 10 percent increase in sales and foreign employment by a U.S. company's foreign subsidiaries results in an increase in exports of goods from the United States and an increase in U.S. employment by the American company of 6.5 percent (see Mihir Desai, C. Fritz Foley, and James R. Hines, Jr., "Domestic Effects of the Foreign Activities of US Multinationals," *American Economic Journal: Economic Policy*, February 2009).

to 1.5 percent of the remitted income). Norway uses a 97 percent exemption standard, which results in a tax rate of approximately 0.8 percent on foreign dividends.

Figure 3.—26 OECD Countries Use Territorial Tax Systems

OECD Home Country Method of Tax on Foreign-Source Dividends			
Method of Taxation	Countries		Dividend Exemption Percentage
<u>Territorial Tax Systems</u>	OECD Countries with Territorial Tax Systems		
Exempt foreign-source dividends from domestic income taxation through territorial tax system¹	Australia, Austria, Canada, Czech Republic, Denmark, Estonia, Finland, Hungary, Iceland, Luxembourg, Netherlands, New Zealand, Portugal, Slovak Republic, Spain, Sweden, Turkey, United Kingdom		100% exemption
	Norway		97% exemption
	Belgium, France, Germany, Italy, Japan, Slovenia, Switzerland		95% exemption
<u>Worldwide Tax Systems</u>	OECD Countries with Worldwide Tax Systems		
	Country	2011 Tax Rate²	
Worldwide system of income taxation with deferral and foreign tax credit	Chile	20.0%	0% exemption
	Greece	20.0%	0% exemption
	Ireland	12.5%	0% exemption
	Israel	24.0%	0% exemption
	Korea	24.2%	0% exemption
	Mexico	30.0%	0% exemption
	Poland	19.0%	0% exemption
	United States	39.2%	0% exemption

¹ In general, territorial tax treatment providing exemption of foreign-source dividends depends on qualifying criteria (e.g., minimum ownership level, minimum holding period the source country, income tax treaty status, and/or the source country tax rate).

² Refers to generally applicable tax rate, including surcharges, of combined central and sub-central government taxes.

In contrast to the current U.S. tax system, a territorial system allows foreign earnings to be reinvested at home at little or no tax cost. It is estimated that between one and two trillion dollars of foreign earnings of U.S. multinationals is currently reinvested abroad, some of which would be expected to be immediately repatriated for use at home if a territorial tax system were enacted. The territorial tax system would be expected to result in a much larger percentage of future foreign earnings being repatriated for domestic uses by U.S. multinationals than would occur under present law.

The use of less than a 100 percent exemption by several of the OECD foreign countries is sometimes justified as in lieu of any disallowance of domestic expenses that indirectly relate to the foreign earnings of a corporation. While a small reduction in the exemption below 100 percent is unlikely to create a repatriation barrier, some question whether in fact any such reduction is justified.³

Limitations on the deduction of domestic costs for these indirect overhead activities generally are not a feature of other territorial tax systems, and the United States should not seek to include such a limitation as part of the adoption of a territorial tax system. While some reduction in the exemption percentage is tolerable as a means of revenue generation under the territorial tax system, in no case should the exemption percentage be less than 95 percent, the lowest exemption rate found in the OECD.

The application of territoriality to foreign branches of U.S. companies is another area of complexity with significant potential unanticipated consequences. In some cases companies are required to operate in foreign countries via branches as opposed to foreign subsidiaries. Alternatives to mandating treatment of branches as foreign subsidiaries must be considered to avoid non-competitive treatment of certain foreign operations.

3. Anti-Base Erosion Provisions

The discussion draft proposes three alternative options intended to address concerns that a territorial tax system would potentially result in a shifting of some income and activities from the United States to low-tax foreign jurisdictions.

Business Roundtable agrees that the movement of any U.S. activities abroad for the purpose of avoiding U.S. income tax is antithetical to the intent of a territorial tax system to increase U.S. economic competitiveness and employment. As noted above, it is the experience of our member companies -- and also the findings of economic research -- that foreign activities of

³ See, Statement of Paul W. Oosterhuis, Skadden, Arps, Slate, Meagher & Flom LLP, "Testimony Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means," November 17, 2011. The basic argument in favor of limiting the exemption is that under a "matching" principle, deductions giving rise to exempt income should be disallowed. It should be noted that domestic expenses that directly support foreign activities are required under current law to be charged out to the foreign subsidiary and are fully taxable at home (and would remain fully taxable under the proposed territorial tax system). As a result, only domestic expenses that indirectly support foreign activities are at issue, such as interest expense, R&D, and general and administrative expenses. However, such indirect expenses arising in the U.S. would not be allowed to be deducted in the foreign jurisdiction even if the deduction were disallowed in the United States. In the case of interest expense, "thin cap" rules (discussed in more detail below) can more appropriately ensure that the domestic corporation is not excessively debt financed relative to its foreign leverage. In the case of deductions for R&D expenses, transfers and licenses of resulting intangible property for foreign use are taxable under territorial tax systems so a full deduction for R&D is appropriate. Transfer pricing regulations generally require charge-out of U.S. general and administrative costs that are incurred to support foreign affiliates, providing an appropriate matching of income and expense. Finally, limitations on deductions for salaries relating to general and administrative expenses could encourage the movement of headquarter jobs to foreign locations that provided a full deduction for these activities, a result that may be in opposition to the intent of the territorial tax system.

U.S. companies on balance complement their domestic investment and employment, so that a territorial tax system should enhance U.S. economic growth, in addition to encouraging the repatriation of foreign earnings for domestic uses.

A concern with the development of any anti-base erosion provision is the difficulty of identifying activities that are undertaken abroad for tax rather than other business motivations such as: cost savings from operating closer to foreign consumers, the presence of local natural resources, and specialized labor, among other factors. Further, certain foreign business structures can help reduce income taxes paid to foreign countries, and are often used by competitors. As a result, anti-base erosion rules that are unlike those adopted abroad can impede the competitiveness of American companies relative to their foreign competitors.

For this reason, any rules which limit the basic application of the territorial system in an effort to reduce income shifting opportunities must be narrowly focused on potential abuses that would result in a reduction of U.S. income tax. Rules that put U.S.-headquartered companies at a competitive disadvantage and result in the loss of sales by U.S.-headquartered companies would be counterproductive to the goal of a territorial system. Care also should be taken to avoid adoption of rules that impose excessive administration and compliance costs.

Each of the three anti-base erosion options proposed in the discussion draft potentially have broad application and have the potential to adversely affect some current overseas operations of U.S. companies that by definition are not motivated by the potential tax savings of a territorial tax system. Some have described the three options as more consistent with the repeal of deferral than the adoption of a territorial tax system.⁴

Business Roundtable appreciates the concern for potential base erosion under a territorial system but believes further dialogue is needed to identify the specific new tax planning opportunities that potentially would arise under a territorial tax system and the experience of other countries with territorial tax systems.

4. Certain Active Business Income Remaining Subject to Anti-Deferral Rules

The discussion draft does not address the temporary provisions that allow deferral of certain active finance income (income derived from the active conduct of banking, finance, and insurance) and of income received from related foreign affiliates ("CFC look-through"). Business Roundtable believes that these temporary provisions should be made permanent under a territorial system. The active financing income rule treats active business income of financial companies in the same manner as active income of non-financial companies. The "look-through" rule treats payments between related foreign subsidiaries as active business income where the underlying earnings are not subject to current U.S. taxation by virtue of arising from active business income.

⁴ See, Statement of David G. Noren, "Testimony Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means," November 17, 2011.

In addition, Business Roundtable believes the current law subpart F rules should be further modified to exclude foreign base company sales, service, and oil-related income. Consistent with the fundamental principle of a territorial tax system, this would permit these foreign business activities to be competitive with foreign-headquartered companies. Safeguards consistent with those applied by other countries with territorial systems may be adopted, if necessary, to address any concerns for potential U.S. base erosion.

5. Interest Deduction Denial

The proposal would deny a deduction for U.S. interest expense where the U.S. company's debt ratio exceeds the global debt ratio of its worldwide group and its domestic interest expense exceeds a yet to be specified percentage of its adjusted taxable income. The proposal would apply to both related and unrelated party debt and would be in addition to current interest limitations applying to related party debt in sec. 163(j).

As described in the Ways and Means Committee document, the intent of the proposal is to prevent disproportionate interest deductions in the United States by U.S. multinationals that erode the U.S. tax base.

The use of thin capitalization rules to limit deductions for interest payments on related party debt is relatively common across countries, although limitations on unrelated party debt are less common. Application of the thin cap rule to unrelated party debt broadly expands the scope of the limitation and therefore should be appropriately tailored to not limit interest deductions that would be expected to arise under normal business considerations. There may also be non-tax operational reasons to justify a higher level of debt in the United States relative to a company's global leverage.

Cyclical businesses may find that their interest expense is large relative to adjusted taxable income during periods of low profitability. In addition to providing a carryforward of denied interest expense, businesses should be allowed to carry forward excess limitation during periods when profitability is high relative to interest expense. The current law sec. 163(j) interest limitation rules provide both such carryforwards, although a longer carryforward period of excess limitation is appropriate under the proposed thin cap rule given its broader application to both related and unrelated party debt.

6. Transition Tax on Pre-Enactment Earnings and Tax on Previously Taxed Income

The proposal would subject pre-January 1, 2013, deferred foreign earnings of 10-percent or greater owned foreign companies to a 5.25 percent tax rate.⁵ The tax is payable in equal annual installments over up to eight years, with an interest charge. In addition, if such

⁵ This is achieved by an 85-percent exclusion of earnings. The provision disallows foreign tax credits associated with the 85 percent excluded income.

earnings are repatriated to the United States, they are subject to the 95 percent exemption system under which a 1.25 percent tax would be levied.

Any transition to a new tax system requires rules for determining how pre-effective date tax attributes are to be accommodated. Significant simplification is achieved by treating pre-effective date earnings in the same manner as post-effective date earnings. Countries recently adopting territorial tax systems, including the United Kingdom's 100 percent exemption system and Japan's 95 percent exemption system, have made pre-effective date earnings fully eligible for their territorial tax systems.

The proposal makes no distinction between foreign earnings that have been reinvested in foreign operations and foreign earnings held as cash or equivalents, nor does it consider whether or not the company has previously declared in its SEC financial statements that such income would be indefinitely reinvested in its foreign operations.

In addition to this transition tax, previously taxed income and future subpart F income (which is taxed on a current basis in the United States) will also pay an additional 1.25 percent tax upon repatriation.

We are unaware of any country that imposed a transition tax on prior earnings when it adopted a territorial tax system or any country that does not fully exempt repatriation of foreign income that has already been subject to domestic tax. Consequently, Business Roundtable recommends further consideration be given to whether there are compelling reasons to depart from international norms.

7. Conclusion

Business Roundtable appreciates the consultation process initiated by the Ways and Means Committee through this hearing and the release of the October 26 discussion draft. The discussion draft reflects important progress toward the adoption of a competitive territorial tax system in the United States and a commitment to a lower statutory corporate rate that is critical to increasing the global competitiveness of U.S.-based businesses and increasing the attractiveness of the United States as a location for investment.

Business Roundtable commends Chairman Camp, Chairman Tiberi and the members of the committee for undertaking this serious effort toward much needed reform.

On behalf of Business Roundtable, I look forward to working closely with this Committee toward this important goal.

Supplemental Sheet

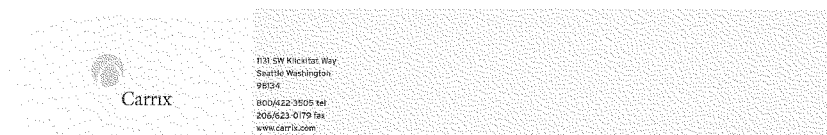
Statement on behalf of Business Roundtable

Submitted by:

The Honorable John M. Engler
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Hearing: Hearing on Ways and Means International Tax Reform Discussion Draft,
November 17, 2011, Subcommittee on Select Revenue Measures



CARRIX, INC.

**STATEMENT FOR THE RECORD
 BEFORE THE SELECT REVENUE MEASURES SUBCOMMITTEE
 COMMITTEE ON WAYS AND MEANS
 U.S. HOUSE OF REPRESENTATIVES**

HEARING REGARDING THE WAYS AND MEANS "DISCUSSION DRAFT"

November 29, 2011

Mr. Chairman, Ranking Member Neal, and distinguished Members of the Committee,

On October 26, 2011, Ways and Means Committee Chairman Camp (R-MI) released a discussion draft of proposed legislation that would significantly amend U.S. international tax rules in the direction of a territorial, or dividend exemption, system (the "Proposal") for comment. In addition, the Proposal reduces the maximum corporate tax rate from 35% to 25%.

Carrix, Inc. ("Carrix") is pleased to submit written comments for the record in connection with the Proposal.

Background on Carrix:

Carrix is a **closely held** U.S.-based port terminal operating company that manages more cargo terminals than any other company in the world. Carrix provides a full spectrum of transportation services, from terminal management to stevedoring, in a number of U.S. and foreign ports.

As a company built on international trade, Carrix fully appreciates the goal of the Proposal: lowering the corporate tax rate and reforming our international tax laws to a territorial regime. The Proposal should make U.S. companies more competitive vis-à-vis their foreign competitors. Carrix, like many other U.S.-based companies in all sectors of the economy, faces fierce competitive pressure from foreign-based companies. Unlike most other U.S.-based companies, many of our foreign-based competitors are large foreign multinationals, some of which are closely aligned with foreign governments, and operate under more favorable home country tax regimes.

Provision of Concern:

In general, Section 301 of the Proposal provides a 95% dividends-received deduction for foreign-source dividends from CFCs (and companies electing to be treated as CFCs), subject to a 365 day holding period. Carrix believes Section 301 of the Proposal imposes tax at a much higher rate than intended on a small group of closely held US multinational companies that are subject to the Personal Holding Company ("PHC") rules established under Sections 541 through 547 of the Internal Revenue Code.

Background on the Personal Holding Company rules:

The PHC tax was enacted in 1934 and, at the time, represented an appropriate response to prevent individuals from sheltering investment income from individual income tax by using their closely held US corporations to hold investments. At the time the maximum individual income tax rate was substantially higher than the maximum corporate tax rate and corporations could be liquidated on a tax-free basis. Neither possibility exists today because of changes to the tax laws, yet the PHC provisions were never updated to reflect more modern circumstances, particularly closely held consolidated groups with foreign affiliates.

The PHC rules impose a corporate level penalty tax of 15% (the rate will become 39.6% in 2013 if the Bush tax cuts expire as scheduled at the end of 2012) on the undistributed PHC Income of a PHC. A corporation constitutes a PHC if 60% of its adjusted gross income is PHC income and if 50% of its stock is owned by five or fewer individual shareholders at any time during the last half of the taxable year. PHC income generally is defined as interest, dividends, royalties, rents, and certain other types of passive investment income. The PHC penalty tax can be avoided by an entity by distributing PHC income to its shareholder(s), resulting in the shareholder(s) paying the appropriate tax on the distribution.

In the case of a group of US corporations filing a consolidated return, the PHC calculations are generally conducted on a consolidated basis. However, in certain circumstances the PHC test and tax computation must be made on a separate company basis. Section 542(b)(2) provides the PHC test must be applied on a separate entity basis if more than 10 percent of an entity's adjusted ordinary gross income is received from a source outside the affiliated group (such as foreign subsidiaries) and more than 80 percent of such adjusted ordinary gross income is PHC income. PHC income would include dividends from foreign subsidiaries.

For each taxable year, if any separate entity included in the affiliated group fails the test under Section 542(b)(2), the entire corporate structure is tainted and each separate entity is potentially subject to the PHC tax. Thus, when the test is conducted on a separate company basis, a US group of corporations filing a consolidated return can easily find that it has a personal holding company tax liability even though a majority of its consolidated revenue may be active trade or business income and it would not otherwise be subject to the PHC tax except for the rules requiring separate company testing.

PHC Rules Applied to the Section 301 of the Proposal:

Under Section 301 of the Proposal, dividends received from eligible CFCs or entities electing to be treated as CFCs would qualify for a 95% DRD.

For companies not subject to the PHC rules (such as public corporations), dividends received from eligible foreign subsidiaries that qualify for the 95% DRD, end up with an effective tax rate of 1.25%. Thus if an eligible dividend received a \$100M dividend from an eligible foreign entity, it would be subject to only \$1.25M of tax (\$5M taxable dividend x 25% tax rate).

In comparison, companies subject to the PHC rules could potentially be subject to a significantly higher tax rate, especially in the common scenario where the foreign dividends are received by holding company whose only significant income are such dividends, even if a majority of the consolidated groups income is not considered PHC income. Companies in this situation would likely be subject to the PHC tax due to the separate company testing required under Section 542(b)(2).

As mentioned above, the 15% PHC penalty tax applies to undistributed PHC income. In calculating the undistributed PHC income, DRDs must be added back; therefore the PHC tax could apply to 100% of the dividend rather than the 5% per Section 301 of the Proposal.

For example, if a subsidiary in a consolidated group subject to the PHC rules on a separate company basis received a \$100M dividend from an eligible foreign subsidiary, and the entire dividend was subject to the PHC tax, the group member could be subject to \$16.06M of tax, calculated as follows

Income Tax	
Dividend	100,000,000
DRD	(95,000,000)
Taxable Income	5,000,000
Income Tax Rate	25%
Income Tax	1,250,000
PHC Tax	
Taxable Income	5,000,000
Add back of DRD	95,000,000
Less Accrued Taxes	(1,250,000)
Undistributed PHC Income	98,750,000
PHC Tax Rate	15%
PHC Tax	14,812,500
Total Tax for PHC Company on \$100M Dividend	
Income Tax	1,250,000
PHC Tax	14,812,500
Total Tax	16,062,500

Thus the tax would be a 1285% increase in tax (16.06/1.25) compared to companies receiving the same dividend that are not subject to the PHC tax. If the Bush tax cuts expire, the total tax for the separate company subject to the PHC tax in this example would increase to \$40.4M.

Proposed Solution:

A proposed solution would eliminate the provisions that require certain consolidated groups of corporations to determine their PHC tax liabilities on a separate company basis.


This solution would not eliminate the PHC tax for a consolidated group of corporations that is determined to be a PHC on a consolidated basis. However, provided that a consolidated group of corporations is determined not to be a PHC on a consolidated basis, these corporations would not pay the additional 15% penalty tax, but would simply pay the same level of corporate tax as a similarly situated publically traded corporation.

Suggested Legislative Text:

- (a) In General. – Section 542(b) is amended by –
 - (1) striking paragraph (2) and (4), and
 - (2) redesignating paragraphs (3), and (5) as paragraphs (2) and (3) respectively.
- (b) Conforming amendments –
 - (1) Section 542(b)(1) is amended by striking “paragraphs (2) and (3) and inserting “paragraph (2)”.
 - (2) Section 1504(c)(2)(B)(ii) is amended by striking “section 542(b)(5)” and inserting “section 542(b)(3).
- (c) Effective Date – The amendment made by this section shall apply to taxable years beginning after December 31, 2012.

Conclusion:

Thank you for the opportunity to submit these written comments for the record. Carrix looks forward to working with you and your staff to ensure that the U.S. tax code is reformed in a way that makes sense, treats similarly situated taxpayers equally, and doesn't penalize certain taxpayers due to certain antiquated provisions of the Internal Revenue Code.



Comments for the Record

**House Ways and Means Committee
Subcommittee on Select Revenue Measures**

Hearing on the International Tax Reform Discussion Draft

November 17, 2011, 10:00AM
1100 Longworth House Office Building

By Michael G. Bindner
Center for Fiscal Equity

Chairman Tiberi and Ranking Member Neal, thank you for the opportunity to submit comments for the record on the discussion draft. We will leave it to others to critique the specific provisions of the discussion draft, as there are foundational questions that must first be addressed.

We believe that a reform of this magnitude should be part of a more comprehensive tax reform program. Recent proposals to cut corporate taxes in the short term, in advance of any reform of personal income taxes or the expiration of favorable rates for this income seem to us to be an attempt to cash in for the short term gain of our wealthiest citizens at the expense of everyone else. Coordinating reform so that any revenue losses due to international rules changes are offset by returning personal dividend taxation to normal income rates will allay these suspicions.

Many nations do not tax repatriated income at all; however these nations often also have consumption tax regimes. Under a consumption tax regime, there would be no separate levy on profit. Value added taxes (VAT) are already paid in the country where the product is sold and these taxes include both the contributions of labor and capital. For the purposes of businesses, profit should not be taxed again when repatriated, except to the extent that this profit results from value added in the United States. Use of VAT exemptions must not be allowed as a tax avoidance scheme. Products with parts that have been produced or developed in the United States, then sent elsewhere for assembly, must reacquire any obligation to pay that was shed at the border. Not providing for this contingency opens the door for a great deal of abuse.

The source nation of dividend income, meanwhile, must be irrelevant for purposes of collection of the proposed high income and inheritance surtax. The subject of this tax is not the income of the business, which has been shifted to the NBRT for individual filers, but the income of households for personal consumption and savings. The existence of this tax takes into account the decreased likelihood that this income will be spent and therefore taxed under NBRT and VAT regimes and to safeguard savings opportunities for the non-wealthy, who would otherwise be priced out of the market for investments by higher income individuals who, because they have greater opportunities to save, garner greater and greater shares of America's wealth. The proposed surtax is an attempt to level the playing field so that everyone can invest.

Let us now turn to the question of comprehensive tax reform. As you know, the Center for Fiscal Equity has a four part proposal for long term tax and health care reform. The key elements are

- a Value Added Tax (VAT) that everyone pays, except exporters,
- a VAT-like Net Business Receipts Tax (NBRT) that is paid by employers but, because it has offsets for providing health care, education benefits and family support, does not show up on the receipt and is not avoidable at the border,
- a payroll tax to for Old Age and Survivors Insurance (OASI) (unless, of course, we move from an income based contribution to an equal contribution for all seniors), and
- an income and inheritance surtax on high income individuals so that in the short term they are not paying less of a tax burden because they are more likely to save than spend – and thus avoid the VAT and indirect payment of the NBRT.

A Value Added Tax (VAT) is suggested because of its difficulty to evade, because it can be as visible to the ultimate consumer as a retail sales tax and because it can be zero rated at the border for exports and collected fully for imports. As such, it is superior to proposals for a FairTax or 9% National Sales Tax. As many others, particularly Michael Graetz, have pointed out, resorting to a VAT rather than imposing trade sanctions has the effect of imposing higher costs on imports and lower costs on exports, without provoking retaliation from our trading partners – mostly because our trading partners already use such a regime. By not adopting a similar tax structure, we essentially tie the hands of our exporters in the fight for international market share. There can be no retaliation when using VAT is already the international standard. In short, if the U.S. adopted a VAT, China would have no countermove as the use of VAT is part of global trade structures.

It is also important is to exercise care in delineating what is funded by a VAT. We believe that VAT funding should be confined to funding domestic discretionary military and civilian spending. Zero rating a tax supporting such spending is totally appropriate, as foreign consumers gain no benefit from these expenditures. Likewise, making imports fully taxable for this spending correctly burdens the consumers who fully benefit from these services. As importantly, making such a tax visible provides an incentive to taxpayers to demand less of such spending.

The NBRT would not be border adjustable because it is designed to pay for entitlement costs which benefit employees and their families directly, so that it is appropriate for the foreign beneficiaries of their labor to fund these costs. Additionally, the ultimate goal of enacting the NBRT is to include tax expenditures to encourage employers to fund activities now provided by the government – from subsidies for children to retiree health care to education to support for adult literacy. Allowing this tax to be zero-rated at the border removes the incentive to use these subsidies, keeping government services in business and requiring higher taxation to support the governmental infrastructure to arrange these services – like the Committee on Ways and Means.

If the NBRT is enacted in this way, the United States should seek modification to our trade agreements to require that similar expenditures not be funded with taxes that are zero rated at the border. As foreign consumers benefit from subsidies for American families, American consumers benefit from services provided to overseas workers and their families. This benefit should be recognized in international tax and trade policy and American workers should not be penalized when other nations refuse to distribute the cost of benefits to foreign workers to the American consumers who receive the benefit of these services. If our trading partners do not match this initiative, some items of spending could be shifted from NBRT funding to VAT funding, so that we are not making unilateral concessions in this area.

Separation of Old Age and Survivors Insurance Payroll taxes from the NBRT is necessary unless the employee contribution is to be totally eliminated with a uniform benefit or uniform. A separate payroll contribution is required as long as benefit levels are set according to income. If a uniform benefit is desired, then payroll taxes can be discontinued and the NBRT expanded. Employee contributions could not be zero rated at the border. If employer contributions are equalized and contributed to a public system, however, they could be incorporated into a VAT rather than an NBRT. This allows the Social Security system to benefit from foreign labor where outsourcing has occurred. Indeed, it would be an essential expansion of the tax base if globalization is to continue unabated.

In the long term, the explosion of the debt comes from the aging of society and the funding of their health care costs. Some thought should be given to ways to reverse a demographic imbalance that produces too few children while life expectancy of the elderly increases.

Unassisted labor markets work against population growth. Given a choice between hiring parents with children and recent college graduates, the smart decision will always be to hire the new graduates, as they will demand less money – especially in the technology area where recent training is often valued over experience.

Separating out pay for families allows society to reverse that trend, with a significant driver to that separation being **a more generous tax credit for children**. Such a credit could be “paid for” by ending the Mortgage Interest Deduction (MID) without hurting the housing sector, as housing is the biggest area of cost growth when children are added.

While lobbyists for lenders and realtors would prefer gridlock on reducing the MID, if forced to chose between transferring this deduction to families and using it for deficit reduction (as both Bowles-Simpson and Rivlin-Domenici suggest), we suspect that they would chose the former over the latter if forced to make a choice. The religious community could also see such a development as a “pro-life” vote, especially among religious liberals.

Enactment of such a credit meets both our nation’s short term needs for consumer liquidity and our long term need for population growth. Adding this issue to the pro-life agenda, at least in some quarters, makes this proposal a win for everyone.

The expansion of the Child Tax Credit is what makes tax reform worthwhile. Adding it to the employer levy rather than retaining it under personal income taxes saves families the cost of going to a tax preparer to fully take advantage of the credit and allows the credit to be distributed throughout the year with payroll. The only tax reconciliation required would be for the employer to send each beneficiary a statement of how much tax was paid, which would be shared with the government. The government would then transmit this information to each recipient family with the instruction to notify the IRS if their employer short-changes them. This also helps prevent payments to non-existent payees.

Assistance at this level, especially if matched by state governments may very well trigger another baby boom, especially since adding children will add the additional income now added by buying a bigger house. Such a baby boom is the only real long term solution to the demographic problems facing Social Security, Medicare and Medicaid, which are more demographic than fiscal. Fixing that problem in the right way definitely adds value to tax reform.

The fourth proposal is a surtax on high incomes from inheritance, wages, dividends and capital gains (essentially all income with the exception of sales to a qualified ESOP). It would fund overseas military operations, which are often debt financed, and net interest and debt repayment.

Explicitly identifying the high income surtax with net interest payments highlights the need to raise these taxes as a means of dealing with our long term indebtedness, especially in regard to debt held by other nations. While consumers have benefited from the outsourcing of American jobs, it is ultimately high income investors which have reaped the lion's share of rewards. The loss of American jobs has led to the need for foreign borrowing to offset our trade deficit. Without the tax cuts for the wealthiest Americans, such outsourcing would not have been possible, including the creation of Chinese industry designed to sell to Americans. Indeed, there would have been any incentive to break unions and bargain down wages if income taxes were still at pre-1981 or pre-1964 levels. The middle class would have shared more fully in the gains from technical productivity and the artificial productivity of exploiting foreign labor would not have occurred at all. Increasing taxes will ultimately provide less of an incentive to outsource American jobs and will lead to lower interest costs overall

Thank you again for the opportunity to present our comments. We are always available to discuss them further with members, staff and the general public.

Contact Sheet

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Hearing on the International Tax Reform Discussion Draft
November 17, 2011, 10:00AM
1100 Longworth House Office Building

All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears:

This testimony is not submitted on behalf of any client, person or organization other than the Center itself, which is so far unfunded by any donations.



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SUBMISSION TO
HEARING ON WAYS AND MEANS INTERNATIONAL TAX REFORM
DISCUSSION DRAFT

NOVEMBER 17, 2011

THE FOLLOWING IS ATTRIBUTABLE TO

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Organization N/A

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November 13, 2011

The Honorable Dave Camp
Chairman
Committee on Ways and Means
United States House of Representatives
Ways and Means Committee Office
1102 Longworth House Office Building
Washington D.C. 20515

Sent by email to: wmtaxreform@mail.house.gov

Dear Mr. Camp:

Re: International Tax Reform –
Suggested approaches to making the
proposed territorial approach better and
more effective

I am providing my comments on the Ways and Means Discussion Draft released October 26, 2011 (W&MDD) concerning international tax reform. This submission focuses on the approach to dealing with accumulated deferred foreign income as included in amended §965 and on a number of suggested approaches to making the proposed territorial approach better and more effective.

Personal Background and Basis for Contributing to this Discussion

I was in private practice working for 32 years in international taxation for several of the major international accounting firms. I now teach several international taxation courses within the Tax LLM program at the University of Washington School of Law. I consider myself to be an expert in the details of international tax planning, both from the domestic and foreign perspectives due to my having lived and worked outside the United States for more than half of my career.

Executive Summary

The most important comments and recommendations are summarized in this Executive Summary. Additional detail and a number of additional comments and recommendations are made in the body of this submission.

- **New §965 –Rewarding Tax Structured Vehicles**

New §965 wisely provides a one-time final solution to the existing “accumulated deferred foreign income” as of the change-over from the current deferral system to the contemplated territorial system.

Since the 2004 American Jobs Creation Act repatriation holiday, many United States-based multinational corporations (US MNCs) have seriously heightened their efforts to maximize earnings in tax havens and other low-taxed foreign subsidiaries in the expectation that there would be another repatriation holiday down the road. In so doing, they have undermined the United States tax base.

Good tax policy cannot reward such behavior.

A practical approach is recommended for identifying “tax structured vehicles” and taxing their earnings over the up-to eight year period at normal corporate rates with an offset for otherwise available foreign tax credits. Foreign earnings that are not within “tax structured vehicles” would be allowed the suggested 5.25% rate.

- **New §245A and §956 – Dividend-Received Deduction Structure and Erosion of US Domestic Tax Base – A Flawed Mechanism Requiring Change**

The proposed territorial system imposes a full 25% rate on domestic income and a zero rate on foreign earnings. The mechanism that implements this requires change.

The W&MDD’s administratively simple mechanism to achieve the intended domestic 25% rate/foreign zero rate structure is a 95% dividend-received deduction. The net 5% remaining in a US shareholder’s taxable income when a foreign dividend is received is not partial taxation of the foreign dividend. Rather, the 5% is meant to achieve “pure” domestic taxable income by offsetting US shareholder expenses that are attributable to exempt foreign earnings. Such amounts should not be deductible in calculating the domestic tax base, to which the 25% rate will be applied. In the words of the Technical Explanation, the net 5% “is intended to be a substitute for the disallowance of deductions for expenses incurred [by the US shareholder] to generate exempt foreign income.”

Because of this net 5% that is added into the domestic tax base whenever a dividend out of foreign earnings is paid, recognition of such a dividend is effectively a “taxable event” because it directly generates a 1.25% tax obligation.

One important intent of this new system is to eliminate the current disincentive to dividend distributions that has caused the stockpiling of otherwise distributable cash overseas. And with the expectation that dividends will be regularly paid once the territorial system and its 95% dividend-received deduction are in place, the §956 Investment in US Property rules will be eliminated since, in the words of the Technical Explanation, they “are no longer necessary.”

In this writer’s extensive experience, the dividend-received deduction mechanism proposed will have the following consequences, which are significantly different from what is intended:

- The domestic tax base will be understated because CFC dividends will be deferred or never paid.

In order to defer or eliminate the 1.25% tax, US MNCs will actively avoid having their controlled foreign corporations (CFCs) pay dividends. This is not an immaterial tax that will be ignored, as is covered in discussion later in this submission. This avoidance will mean deferral for some number of years or indefinite reinvestment, in which case the 1.25% tax will never be paid.

To the extent that US MNCs avoid the payment of foreign dividends through deferral or reinvestment, the net 5% inclusion meant to achieve “pure” domestic taxable income will be similarly delayed or eliminated. And this means a major understatement of the current domestic tax base. There will have been insufficient or no offset for US shareholder expenses attributable to exempt foreign earnings.

- Now that US shareholders are free of §956, CFCs with excess cash will simply make loans to their US shareholders and group members.
- Interest on these loans, even with the tightened earning stripping rules in §163, will erode the 25% domestic tax base.
- This interest flow will create a strong incentive for tax arbitrage by creating a current interest deduction with a 25% benefit within a US MNC group debtor and a “potential” future 1.25% tax cost from the increased earnings in the CFC. (Although the interest income would be foreign personal holding company income, the §954(b)(3)(A) de minimis rule will often eliminate this result, thereby allowing such interest income the benefit of the participation exemption.)

Because of the above consequences, the present mechanism (the 95% dividend-received deduction) is flawed and must be changed. In particular, the mechanism calculating the offset that creates “pure” domestic taxable income cannot be the payment of dividends, an event that is discretionary to the US MNC.

This writer proposes a new mechanism for the proposed participation exemption regime that will clearly achieve two goals:

- Repatriation to the US of overseas earnings as dividends unaffected by any federal tax consequences, and
- Avoidance of erosion of the US tax base through an offset mechanism that is neither itself a “taxable event” (as is the current mechanism) nor within the discretion of the taxpayer to control.

The proposed mechanism is the creation of a new category of subpart F income defined to include a calculated percentage of all gross income of the CFC. And the dividend-received deduction would rise to 100%.

This writer suggests no specific percentage; appropriate research should determine it. In any case, as simply an example, if 1.5% were used, then a US shareholder that wholly owns a CFC with \$1 million of gross income would include \$15,000 in its domestic tax base as the offset to account for expenses attributable to exempt foreign earnings.

Under this proposed mechanism, the above two goals are fully met:

- As dividends would be fully offset by a 100% dividend-received deduction, their payment would no longer be a “taxable event”. As such, CFCs could distribute their earnings to their US shareholders based on commercial need and other legal factors and not primarily based on US federal tax considerations.
 - Base erosion would be avoided and “pure” domestic taxable income achieved through the current subpart F income inclusion.
- **New §245A – Effect of Subpart F §954(b)(3)(A) De Minimis Rule – Need to Amend to Reflect Territorial System or Eliminate Completely**

If the §954(b)(3)(A) de minimis rule is left unchanged or is not eliminated, then potentially material amounts of what would otherwise be subpart F income will receive the benefit of the participation exemption.

- **New §245A(b)(2) – Treatment of Foreign Branches**

Treating a foreign branch as a CFC is not promoting simplicity. Make this CFC treatment elective.

There can be considerable difficulty carving up the activities, assets and risks of a single legal entity between a home office and branch. This can be especially true where there is valuable intellectual property used by a branch. Since calculating branch income will be necessary for any foreign branch treated as a CFC, consider providing additional regulatory guidance on this issue.

A policy decision is needed regarding whether a foreign tax credit would be allowed to the US shareholder of a foreign branch treated as a CFC where the country concerned imposes a branch profits remittance tax, which is similar to our §884 branch profits tax.

New §245A(b)(2)(B) defines foreign branch by looking to the United States trade or business concept, which means that only a very low threshold of activity in a host country is required for a foreign branch to exist. There will be many situations where there will be a foreign branch under this concept, but that branch will not be taxable in the host country under either the host country's domestic law or an applicable treaty. This will cause income attributable to the foreign branch to escape both host country taxation and United States taxation due to the participation exemption.

If this situation is allowed to exist, United States taxpayers will work hard to create foreign branches that are tax-free in their respective host countries. This writer suggests two approaches to eliminate this situation, which will become a major area of abuse.

- Leave branches to be taxed as they are now by deleting §245A(b)(2) (i.e., no participation exemption), or
- Amend the definition to treat a branch as a CFC only if the host country actually taxes the income using the §954(b)(4) standard (i.e., at an effective rate that is greater than 90% of the maximum §11 rate (i.e., 22.5%, which is 90% of the proposed 25% corporate tax rate).

• **New §1247 – Issues Concerning Sales and Exchanges**

When a US shareholder sells or exchanges shares of a CFC, there may be gain attributable to two components that should not receive the benefit of the new participation exemption. These two components are (i) any appreciation in passive assets held by the CFC, and (ii) any CFC earnings that would have been subpart F income but which were protected by the §954(b)(3)(A) de minimis rule.

To the extent of gain attributable to these two items, the US shareholder taxation should be at the 25% rate with a deemed-paid foreign tax credit allowed.

Once this change is made to tax such amounts at the 25% rate, the 70% requirement for “qualified foreign corporation” status in §1247(b)(1) could logically be eliminated.

If the above suggested changes are not made, then the present 70% percentage test should be raised to a much higher percentage (say, 95%) since this low 70% will allow many US shareholders to indirectly sell significant non-active-business assets and cumulative undistributed §954(b)(3)(A) de minimis rule protected income held within the CFC and be fully covered by the new §1247 participation exemption. This is simply not appropriate and will further encourage the movement of assets and income from the US into CFCs.

To be consistent with the §1247(a)(2) disallowance of any loss from the sale or exchange of stock of a qualified foreign corporation, §165(g)(3) must be amended so that the US shareholder is denied a deduction for any worthless security loss of its CFC.

- **New §245A – Noncontrolled 10/50 Corporations – Foreign Tax Credit**

Where no election is made under new §245A(b)(1)(A), the tax results are:

- Full taxability to the US shareholder of dividend distributions at the 25% rate (i.e., no application of the participation exemption),
- No deemed-paid foreign tax credit as exists under current law for taxes imposed on the noncontrolled 10/50 corporation, and
- A §901 foreign tax credit for any foreign withholding or other taxes imposed on the US shareholder recipient of the dividend distribution

As clearly shown in a chart in the body of this submission, these results cause double-taxation in comparison with the result under current law. This represents a penalty that cannot be intended.

There are two possible solutions:

- Continue §902 solely for nonelecting noncontrolled 10/50 corporations
- Eliminate the §245A(b)(1)(A) election and make CFC characterization mandatory for all noncontrolled 10/50 corporations

While either will provide a solution, this writer believes the first approach is preferable since a minority US shareholder may not have access to the information necessary to apply subpart F annually.

- **New §904(b)(3) – Indirectly Allocable Expenses – Erosion of Domestic Tax Base**

This amendment has nothing to do with the planned transition to a territorial system and will only erode the domestic tax base by allowing excess foreign tax credits to be used against domestic source taxable income. It must be deleted from this proposal.

It may be added that from the equity and fairness perspectives, this amendment is giving an advantage to US MNCs in comparison to pure domestic corporations that pay no foreign taxes.

- **Deletion of §904(d) – Separate “Baskets”**

The adoption of a territorial system does not eliminate the need for the separate baskets of §904(d). Whether speaking of individual taxpayers or corporate taxpayers, all will still have different types of foreign source income and they will plan their actions in order to allow maximum “cross-crediting” so that the foreign tax credits generated by highly taxed foreign income may reduce the US tax on low or non-taxed foreign sourced income.

This writer strongly suggests that §904(d) be retained as it is. Any wholesale elimination of §904(d) would significantly reduce the US tax base at a time when the goal should be to expand it. Having said this, this writer does agree that a review of §904(d) for possible simplification is appropriate, but only subsequent to any changes that Congress makes to the overall taxation of foreign income (e.g. after changing the current deferral system to a territorial system).

- **§909 – Repeal**

Current §909 should be dealt with in a similar manner as that suggested above for §904(d). As such, §909 should be retained and only reviewed for deletion or amendment subsequent to any changes that Congress makes to the overall taxation of foreign income.

- **§§959 and 961 – Elimination**

Because subpart F remains a very important part of our taxation system once a territorial system is adopted, it is vitally important that §§959 and 961 be retained. Without their retention, the §245A and §1247 mechanisms will cause some double taxation of any previously taxed income when dividend distributions are made or when a CFC’s shares are sold or exchanged.

Such a result cannot be intended.

This writer recommends that §§959 and 961 be retained and appropriately amended to reflect the new participation exemption system. For example, the ordering rules could logically be changed to require that distributions be treated as first coming out of non-subpart F income (so that the 5% adjustment will fully apply) and only after such non-subpart F income is exhausted out of §959 previously taxed income.

- **Option A – New category of subpart F income for intangibles**

Transactions will only be includible as foreign base company excess intangible income if covered intangibles are “used directly or indirectly” in the relevant sales, services, etc. Tax authority auditors will clearly have great difficulty identifying §936(h)(3)(B) intangibles used where a US shareholder maintains that there are only normal business intangibles (e.g. goodwill) and therefore does not voluntarily include such transactions in the foreign base company excess intangible income calculation.

Because of this near impossibility for tax authority auditors to properly audit this new foreign base company excess intangible income category, there must be a presumption that all of a CFC's sales, services, etc. will be treated as foreign base company excess intangible income unless the taxpayer is able to establish otherwise.

The 10% to 15% range for phasing out this new foreign base company excess intangible income is too low and will encourage "game-playing" to achieve a 15% foreign tax rate so as to avoid subpart F treatment.

Tax policy should attempt to discourage this sort of "game-playing". This writer suggests that the existing and well-known standard of §954(b)(4) be used (i.e. the effective tax rate being over 90% of the maximum §11 rate, which would be taxation in excess of 22.5%). For simplicity, with this higher level of 22.5%, there's no need for the presently proposed phase-out that occurs between 10% and 15%.

- **Option B – New Low-Taxed Cross-Border Foreign Income**

The 10% rate is much too low. The same comments generally apply as those made above concerning new §331A that deals with excess income from intangibles. As such, to discourage game-playing that simply benefits some jurisdiction that is happy to impose a 10% tax, the §954(b)(4) standard should be used in place of 10%.

Acceptable activities should include manufacturing by the CFC within its country of incorporation of products that are exported rather than only locally consumed. If deemed necessary because of concerns about the export of jobs from the United States, then there should be subpart F treatment (i.e., current US shareholder taxation at the 25% rate less any applicable deemed-paid foreign tax credits) to the extent that manufactured products are sold for consumption, use, or disposition in the United States.

- **Option C – New Foreign Intangible Income**

This is bad tax policy and a terrible approach that should be abandoned.

First, it would create a nightmare of subjective and miserable-to-resolve valuation questions between taxpayers and the US tax authorities.

Second, it is a gift to every US MNC that likes to "play games". And that's a pretty high percentage of the universe of US MNCs. In addition to pushing the envelope with regard to subjective valuation issues, the in-house tax personnel within US MNCs and their advisors will spend considerable time and effort scrubbing each manufacturing, sales, service, and other relevant operation to identify all the previously unidentified §936(h)(3)(B) intangibles...previously unidentified because there had been no reason to identify them. All of this effort will be economically unproductive.

Third, it will reduce the domestic tax base.

Fourth, this gift would reward existing behavior that taxpayers are conducting without any governmental encouragement. A taxation-based mechanism intended to increase “foreign intangible income” should reward only the increase. If this Option C is to be considered further, some mechanism would need to be developed to reward only the increases and not the existing base.

- **Which of the Three Options Should Be Used?**

If the Option B safe harbor rate is increased to the §954(b)(4) 90% of the maximum §11 rate (22.5%), this writer sees that as the best.

If this Option B safe harbor rate is not increased, then Option A is acceptable, especially if the changes recommended above are made.

Option C should not be considered at all.

Detailed Discussion of Issues and Recommendations

My comments regarding the new participation exemption and related law changes include the following:

1. New §965 – Adjustment Needed to Avoid Rewarding Tax Structured Vehicles
2. New §245A and §956 – Dividend-Received Deduction Structure and Erosion of US Domestic Tax Base – A Flawed Mechanism Requiring Change
3. New §245A – Effect of Subpart F §954(b)(3)(A) De Minimis Rule – Need to Amend to Reflect Territorial System or Eliminate Completely
4. New §245A(b)(2)(A) – Treatment of Foreign Branches
5. New §245A(b)(2)(B) – Foreign Branch Defined
6. New §245A and §246(c)(5) – Effect of Becoming a CFC
7. New §1247 – Issues Concerning Sales and Exchanges
8. New §245A – Noncontrolled 10/50 Corporations – Foreign Tax Credit
9. New §904(b)(3) – Indirectly Allocable Expenses – Erosion of Domestic Tax Base
10. Deletion of §904(d) – Separate “Baskets”
11. §909 – Repeal
12. §§959 and 961 – Elimination
13. §1248 – Continued Application
14. §960 – Effect of Elimination of §902
15. Option A – New category of subpart F income for intangibles
16. Option B – New Low-Taxed Cross-Border Foreign Income
17. Option C – New Foreign Intangible Income
18. Which of the Three Options Should Be Used?

1. New §965 – Adjustment Needed to Avoid Rewarding Tax Structured Vehicles

New §965 wisely provides a one-time final solution to the existing “accumulated deferred foreign income” as of the change-over from the current deferral system to the contemplated territorial system. In its present form, however, §965 seriously rewards those US MNCs that aggressively maximized low-taxed overseas earnings after the 2004 American Jobs Creation Act repatriation holiday in anticipation that there would be another such holiday down the road. Such a reward violates “equity” and “fairness” concepts since the more aggressive planning will provide a very significant benefit in comparison to US MNCs that were more conservative in their planning and pure domestic corporations that of course did not such planning at all.

With the above in mind, a more appropriate approach would be to find an administratively simple means of providing the suggested 5.25% rate only to “accumulated deferred foreign income” that was earned within countries where actual operations took place and to apply some higher rate (say, 35% but with a foreign tax credit available to reduce this tax) to such income earned within “tax-structured vehicles”. (While my suggested 35% may seem high, the equity and fairness issues coupled with the up to eight-year amortization period allowed for collecting this tax still makes it a relative gift, despite the interest charge for deferred payment.)

How to identify such “tax-structured vehicles”? While one’s imagination could come up with a number of possibilities, I believe that the simplest approach would be the following:

- First create a listing of countries that have the capability of being used for such tax structured vehicles. Such a listing would include the typical tax havens (e.g. Cayman Islands, Bermuda, etc.) as well as some other countries where legitimate business activities do in fact sometimes occur (e.g. Switzerland, Ireland, Singapore, Luxembourg, etc.).

- Second, apply a rebuttable presumption that the US shareholders of CFCs and “10-percent owned foreign corporations” established or tax resident in these listed countries will be subject to the 35% tax (as reduced by any available foreign tax credits) on the undistributed accumulated earnings within these CFCs and “10-percent owned foreign corporations”.

- Third, direct that the US Treasury set out objective criteria for the rebuttal of this “presumption” so that legitimate business activities within the country of incorporation may achieve the 5.25% rate. For example, a Singapore manufacturing operation within a CFC established in Singapore that has a low-effective tax rate due to low local tax rates and/or local tax incentives should be allowed the 5.25% rate. Similarly for an Irish CFC whose business is the local distribution of US manufactured products. Where one CFC or “10-percent owned foreign corporation” has both activities that meet the objective criteria and activities that do not, then the “accumulated deferred foreign income” would be apportioned between the portion that qualifies for the 5.25% rate and the portion that does not.

This approach would clearly label as tax-structured vehicles many of the tax motivated arrangements that were highly publicized in the press this past year. Such arrangements have allowed many US MNCs, especially in the high-tech, pharmaceutical and industrial spheres, to reflect very low effective tax rates in their financial statements. The content of the Joint

Committee on Taxation prepared Present Law and Background Related to Possible Income Shifting and Transfer Pricing, JCX-37-10 dated July 20, 2010, will provide excellent background to the US Treasury in developing the objective criteria.

2. New §245A and §956 – Dividend-Received Deduction Structure and Erosion of US Domestic Tax Base – A Flawed Mechanism Requiring Change

The Issues to Be Addressed

The proposed territorial system is intended to free foreign earnings from US tax and eliminate the current disincentive to dividend distributions that has caused the stockpiling of otherwise distributable cash overseas. Does the territorial income structure proposed in the W&MDD accomplish this? And, will there be any effect on the US tax base?

As indicated in discussion and recommendations below, there's a very real need for a different mechanism if these goals are to be achieved. This writer believes that the proposals, as presently drafted, will not only continue the stockpiling of earnings outside the US, but will also cause a reduction in the US tax base.

Background

As we all know, a major argument for changing from our current deferral system to a territorial system is that US MNCs will in fact repatriate their accumulated foreign earnings through actual dividends and use those repatriations within the US, thereby creating US jobs. With these actual dividend distributions, the domestic group members of US MNCs would no longer borrow money while their foreign group members stockpile massive amounts of cash held permanently outside the US (avoiding the current system's up-to "35% toll charge" upon repatriation). This writer strongly believes that the W&MDD, as presently structured, will not cause actual distributions of future exempted earnings back to the US.

In brief, the proposed territorial system with its effective 1.25% tax imposed on actual dividend distributions along with the proposed elimination of §956 (Investment in US Property rules within subpart F) will result in many inter-company loans from foreign group members of US MNCs to domestic group members. The interest flow from such loans will reduce the US tax base and provide significant tax arbitrage benefits, despite some amelioration from the proposed tightening of interest deductions on such inter-company loans. And the lack of dividend distributions will mean that the 1.25% tax is not paid, thereby further reducing the US tax base.

In summation and as discussed in more detail below, the mechanism for the proposed participation exemption regime must be changed (i) to achieve the desired repatriation to the US of overseas earnings as dividends, and (ii) to avoid a serious erosion of the US tax base.

Explanation of Issues

Under the proposed participation exemption, there will be an effective 1.25% tax on actual dividend distributions. As such, unless there are rules to somehow "gently encourage" actual

distributions or some change in mechanism that eliminates this 1.25% tax on actual distributions, US shareholders will find ways to avoid the need for actual distributions while still using their accumulated overseas earnings in the US. With the elimination of §956 from subpart F, there will be complete freedom for CFCs to make legitimate loans to their US shareholders at “arm’s length” interest rates.

Everyone appears to assume that this 1.25% is a small price that taxpayers will be happy to pay. No, this is not correct. In this writer’s 32 years of experience working with major US MNCs, if there are two legal ways to accomplish something without differing tax risk, the way that achieves the objective at the lowest tax cost will invariably be chosen.

How important is this 1.25%? Given that many major US MNCs are earning billions of dollars annually within their foreign group members, it is not inappropriate to ask what 1.25% of \$1 billion is. It’s \$12.5 million. Amounts much smaller than this motivate in-house corporate tax departments as well as outside attorney and accounting tax advisors who advise their many clients.

And speaking of motivation, remember that the accounting rules allow this 1.25% to be excluded from financial statement tax expense, thereby increasing reported earnings...if it is indefinitely reinvested overseas. Is there any corporate tax director in America today who would not jump at the chance to reduce his company’s tax expense? This is a measure of his performance just like earnings per share and share price are performance measures for the CEO.

What about the IRS? Won’t they jump on this? Generally, no. Under existing tax law and principles, the IRS in their role can assert shareholder taxability from a constructive dividend where a corporation has effectively passed its assets to a shareholder, but such assertions are likely limited to situations where unsophisticated taxpayers haven’t been careful with their paperwork and documentation. That’s why provisions like §956 had to be put in place to turn a legitimate loan into a constructive dividend.

The point of this discussion is that the existence of this 1.25%, payable only when an actual dividend distribution is made, means that very few actual dividend distributions will be made.

Now for a different focus on this 1.25% tax on actual dividend distributions.

Although the surface effect and appearance of the new participation exemption is that a 1.25% tax is being applied to dividend distributions received by US shareholders, it is not intended to be a tax on foreign earnings. Rather, the intent is that distributed foreign earnings will be fully tax-free to US shareholders with the 5% that’s included in taxable income being merely an offset to overstated expenses against normal domestic income. In the words of the Technical Explanation provided with the draft legislation:

“This taxation is intended to be a substitute for the disallowance of deductions for expenses incurred [by the US shareholder] to generate exempt foreign income.”

This means that if actual dividends are not paid, there will be no 5% offset recognized by the US shareholder, resulting in overstatement of expenses against domestic US income.

To summarize the issue, because the 5% only offsets excess expenses that have been deducted against domestic income, any delay of the payment of actual dividends and therefore delay in recognition of this 5% offset means that current domestic taxable income is being understated.

This is a real reduction of the domestic tax base.

If the effect is only 1.25% of the amount of distributions, how significant is this from a government revenue perspective?

This writer is not an economist and has not attempted to calculate or look for any numbers to support his strong suspicions. Having made this admission, though, with the W&MDD as presently drafted, this writer bases his strong suspicion of serious materiality on:

- The ability to "permanently" defer actual distributions because of the ease of making legitimate loans to domestic group members of a US MNC, especially now that §956 will have been stricken from the tax law,

- The fact that there will be continued reinvestment of foreign earnings in new foreign businesses and investments (such reinvestments clearly being real and material in amount as evidenced by the financial statement disclosures of US MNCs over the past decade), meaning that such reinvested foreign earnings will never be repatriated as dividend distributions to US shareholders, and

- The seriously high quantum of foreign earnings (not only annually but especially when these earnings are accumulated over a number of years).

And of course the accounting rule that allows the 1.25% to be eliminated from financial statement tax expense if the related income is indefinitely reinvested is another strong encouragement to not repatriate these overseas earnings.

In this writer's mind, it is crystal clear that this reduction of the domestic tax base will be very very material in amount, especially as the numbers grow over a period of years.

And as noted above, the territorial system changes along with the elimination of §956 will cause many loans by CFCs to their US shareholders and other domestic group members that will incur interest charges. Yes, the proposed changes to §163 adding new subsection (n) as well as existing §163(j) will reduce the effect some, but these interest payments will still cause some reduction of the US tax base.

One might also say that such interest income in the hands of a CFC lender will be foreign personal holding company income and therefore create subpart F income, thereby causing an offset to any interest expense achieved within domestic group members. While this is true, such interest income will often be excluded from subpart F income by the de minimis rule of

§954(b)(3)(A). Where a US MNC and its in-house tax personnel and advisors can achieve this (and you can bet that they will consciously work very hard to do so), there's a pretty nice tax arbitrage: a full interest expense against group domestic income providing a 25% tax benefit and interest income within the CFC that will likely never be subject to any US tax (or if it is distributed, at a maximum rate of 1.25%).

How to Change the Presently Proposed Legislation

There's a serious erosion of the domestic tax base and US MNCs will continue to stockpile their foreign earnings. If we're going to continue with this territorial tax system that features a participation exemption, then how could we change the system to eliminate this detrimental effect on the US tax base?

The stated intent of the participation exemption is to eliminate 100% of the tax from foreign earnings. The 5% taxable portion when actual dividends are paid is merely "a substitute for the disallowance of deductions for expenses incurred [by the US shareholder] to generate exempt foreign income".

To achieve this perfectly stated intent, the new tax law must simultaneously impose zero tax on foreign earnings and a 25% tax on "pure" domestic taxable income. To calculate "pure" domestic taxable income, there must be an annual adjustment to domestic taxable income to achieve this "deduction disallowance".

Under the W&MDD, the "event" causing this "deduction disallowance" adjustment is the payment of an actual dividend. And, as explained above, because this "event" causes the 1.25% tax liability, the many creative taxpayers out there will work hard to avoid paying dividends...or at least defer their payment for as long as possible. Because of this situation, this present approach in the proposed legislation is clearly flawed. The payment of the dividend can simply not be the "event" that generates the "deduction disallowance" within the US shareholder. This "event" must be changed.

The current subpart F mechanism provides us an approach to calculating and making a "deduction disallowance" adjustment so as to arrive at "pure" domestic taxable income within the US shareholder. In brief, a new category of subpart F income would be defined to include a calculated percentage of all gross income of the CFC (before any deductions as allowed by §954(b)(5)). (Gross income must be used as the base and not net earnings after all expenses. This will prevent situations where a CFC may operate at a loss, causing there to be no adjustment to the US shareholder. Whether a CFC itself has net income or loss, there will still be real expenses within the US shareholder that must be disallowed as deductions.) This calculated amount of subpart F income would be included in the income of the US shareholder under §951(a)(1)(A) and would specifically not be affected by the §954(b)(3)(A) de minimis rule, §954(b)(5) deductions, or the §952(c) earnings and profits limitations.

The above recommends calculating the "deduction disallowance" adjustment based on a percentage of gross income of the CFC. An alternative approach could be to define this new category of subpart F income as a percentage of some defined base of the US shareholder's

expenses or even an actual expense allocation based on good regulatory guidance (e.g. Treas. Reg §1.861-8, etc.). This recommended approach of using the gross income of the CFC as a base seems simplest in application and also recognizes the relative size and importance of the CFC and its activities, which arguably would be reflected in how much time, effort and expense the US shareholder pays to the CFC.

Regarding what percentage of gross income to use, this writer has no suggestion for any specific percentage. Those considering this aspect should make appropriate research and arrive at some supportable percentage.

To illustrate the beneficial effects of this suggested approach, say that it is determined that 1.5% of each CFC's gross income represents a reasonable estimate of applicable US shareholder expenses that relate to foreign exempt income. Including this 1.5% in a new category of subpart F income would be the mechanism used as a replacement for the presently proposed 5% of actual dividends paid. And, with this new mechanism being put in place, the §245A dividend-received deduction would be increased from 95% to 100%. With this 100% dividend-received deduction, there will no longer be any federal income tax reason for delaying actual dividend payments. This will mean that CFCs can distribute their earnings to their US shareholders based on commercial need and other legal and tax factors. (Other tax factors that would continue to exist include, for example, foreign withholding taxes and state tax consequences of dividend distributions.)

It should be noted that US shareholders will have various legitimate reasons for wanting certain of their CFCs to retain earnings and not regularly distribute actual dividends. Such legitimate reasons could include, for example, local legal restrictions on dividend payments, a business or local credit need for a larger local balance sheet, or where there's a significant local dividend withholding tax that is not fully exempted by an applicable tax treaty.

Recognizing that there may be local reasons for not regularly distributing dividends, consideration could be given to including in the proposed legislation regulatory guidance to the Treasury to exempt from §482 coverage any non-interest bearing or below-market interest rate loans from such CFCs to domestic members of their group. (Note that Treas. Reg §1.7872-5T already allows this, but does not override any potential §482 application. See Treas. Reg §1.482-2(a)(3).) Taxpayers would presumably only make such non-interest bearing or below-market interest rate loans where local tax authorities allow it.

To further prevent any of the above described tax arbitrage that could arise from interest on loans by CFCs to US shareholders, the §954(b)(3)(A) de minimis rule should provide that any foreign personal holding company income from interest income received from a US related party will not be protected by the de minimis rule. That would assure that interest expense deductible against 25% taxed income will be offset by a §951(a)(1)(A) inclusion that will be included in 25% taxed income. (Note that elsewhere in this submission, there is a suggestion that the §954(b)(3)(A) de minimis rule be deleted from subpart F.)

In the event that the above suggestion to eliminate the 1.25% tax at the time of dividend payment is not made so that the taxable event remains the actual receipt of a dividend distribution, then it

is imperative that §956 remain in effect. To eliminate it means that through simple inter-company loans and other devices, the 1.25% tax will be easily deferred and in many cases never paid. In addition to retaining §956, appropriate changes to existing rules would need to be made to allow §956 investments in US property in excess of §951(a)(1)(A) recognized income to be taxable at the 1.25% effective rate rather than at the 25% rate that would otherwise apply.

If it is necessary to keep §956 in effect, then appropriate portions of §§959 and 961 should logically be retained as well.

3. New §245A – Effect of Subpart F §954(b)(3)(A) De Minimis Rule – Need to Amend to Reflect Territorial System or Eliminate Completely

When a first tier CFC makes a distribution to one or more US shareholders, its distributions can arise from the following categories of earnings and profits:

- Non-subpart F income (determined without regard to the de minimis rule of §954(b)(3)(A) and the new “tier” rule of §245A(f)(1)),
- Distributions received directly or indirectly from second tier and lower tier CFCs that are out of non-subpart F income earned by those CFCs (again, determined without regard to the de minimis rule of §954(b)(3)(A)),
- Amounts of income that would be foreign base company income within any CFC in the chain but which were excluded from that category by virtue of the de minimis rule of §954(b)(3)(A), and
- Amounts previously taxed under §951(a).

Under §245A(a) as presently drafted, distributions out of the first three categories would receive a full participation exemption. Such favorable treatment, however, is only appropriate to the extent of earnings distributed from non-subpart F income earned by CFCs in the chain (i.e., the first two categories). It is not appropriate at all to grant the new §245A participation exemption to the extent of any earnings that would have been subpart F income were it not for the de minimis rule of §954(b)(3)(A).

The §954(b)(3)(A) de minimis rule has a relatively high \$1 million limit (ignoring the 5% limit that would not be relevant for many large CFCs). This is not an insubstantial amount. And importantly this de minimis rule is applied on a CFC-by-CFC basis (except where an anti-abuse rule applies—see Treas. Reg §1.954-1(b)(4)). As such, any US MNC with numerous large CFCs could easily apply the participation exemption to potentially millions that would have been subpart F income in the absence of the de minimis rule. Even medium sized US MNCs could shelter very significant amounts.

It may be added that passive income (e.g. interest, dividends from non-CFCs, etc.) earned directly by a US corporation will be subject to the normal 25% tax. Where such a US corporation is the US shareholder of one or more CFCs that have available de minimis rule

limitation, there will be a very strong incentive to move those passive income assets into the CFCs since doing so will shelter the income from tax under the new §245A participation exemption. (Of course, where any passive assets are transferred to a CFC, there would potentially be either §482 or §367 consequences to the extent of any gain. Non-appreciated assets, though, could generally be transferred without issue.)

A de minimis rule makes good sense when it is only making things simpler. And this is theoretically true under the current deferral system since any earnings excluded by the de minimis rule from a §951(a)(1) income inclusion will be fully taxed at some future date either when actually distributed or under §1248 when the CFC is sold. However, once the new §245A participation exemption becomes law, the “simplifying” de minimis rule creates a major tax benefit that cannot be intended.

Because of the above, new §245A must provide that the participation exemption will not apply to distributions that escaped current subpart F treatment due to the §954(b)(3)(A) de minimis rule.

One mechanism to achieve this is to track the amounts that have benefited from the de minimis rule within any chain of CFCs. An alternative and much better mechanism to achieve this would be to completely eliminate the §954(b)(3)(A) de minimis rule so that all such amounts will be currently taxed to the US parent under §951(a)(1)(A). Not only is this a much simpler approach both for applying new §245A and new §1247, but it is also the most logical approach since with the elimination of the current system’s deferral mechanism, all foreign personal holding company income, foreign base company sales income, etc. should be immediately taxed. (Based on these suggestions, §§959 and 961 should logically not be eliminated as they now are in the proposed legislation.)

4. New §245A(b)(2)(A) – Treatment of Foreign Branches

Foreign branches are to be treated as CFCs on a mandatory basis.

Given the serious complexities that arise from this treatment (§482, subpart F, §367), this writer strongly suggests that this CFC treatment be elective and not mandatory. Such mandatory treatment is not simplification. Where a US corporation chooses to not elect CFC treatment, then the foreign branch’s income would be taxable at 25% with that tax being reduced to the extent of §901 foreign tax credits.

Irrespective of whether this foreign branch treatment is mandatory or elective, additional regulatory guidance on the calculation of branch income could be helpful. See the OECD Report on the Attribution of Profits to Permanent Establishments, Parts I, II, and III, issued December 2006.

The Technical Explanation states that there would be no foreign tax credit allowed for any foreign tax imposed on a foreign branch (aside from any §960 deemed-paid foreign tax credit on subpart F income). Some countries impose a branch profits remittance tax, which is similar to our §884 branch profits tax. There will need to be a policy decision made regarding whether to

allow a credit for such a tax under §901 to the extent that such tax is attributable to any subpart F income included in the US shareholder's gross income under §951(a)(1)(A).

5. New §245A(b)(2)(B) – Foreign Branch Defined

This provision looks to the United States trade or business concept to define “branch”. As this concept can sometimes involve relatively little activity, there will undoubtedly be many branches to which §245A will apply where the host country will not tax the branch. This may be because under the host country's domestic law the activities do not rise to the level of a taxable presence since many countries do have taxability thresholds that are much higher than our United States trade or business concept. Some countries use in their domestic law as a taxability threshold a permanent establishment definition that is similar to that found in the OECD Model Tax Convention or that of the United Nations. Or, there may be an applicable tax treaty between the United States and the host country and the activities do not rise to the level of a permanent establishment as defined in the treaty.

If a branch is not taxed by the host country and also qualifies for the §245A dividend-received deduction, then there will be no income tax applied at all to the branch's income. (This of course ignores for simplicity the net 5% which is included in taxable income and which, in any case, is intended to offset US shareholder deductions attributable to exempt foreign earnings.)

First, it seems doubtful that US tax policy will want to encourage situations where no income taxation is imposed at all.

Second, the attraction of zero taxation in such a branch will seriously encourage the placement of activities into branches that are free of host country tax whether due to that country's domestic law or an applicable treaty. This is bad tax policy.

There are two alternative approaches to dealing with this:

- Leave foreign branches as they're now treated by deleting §245A(b)(2)

This would mean that the proposed 25% rate would apply to branch income with that tax being offset by any available §901 foreign tax credit.

- Amend the §245A(b)(2)(B) definition of branch

Amend the definition to treat a branch as a CFC only if the host country actually taxes the income using the §954(b)(4) standard (i.e., at an effective rate that is greater than 90% of the maximum §11 rate (i.e., 22.5%, which is 90% of the proposed 25% corporate tax rate).

6. New §245A and §246(c)(5) – Effect of Becoming a CFC

Assume that a US MNC holds an interest in a non-CFC/non-PFIC that has significant passive earnings accumulated in prior years. Assume further that there is no §245A(b)(1)(A) election in effect to treat noncontrolled 10/50 corporations as CFCs.

As this writer understands the construction of §245A, by simply making the foreign corporation into a CFC (e.g. through making the §245A(b)(1)(A) election or by increasing the ownership percentage to over 50%) and waiting the relatively short period to meet the holding period test of §246(c) as amended, the accumulated passive earnings will receive the participation exemption when distributed as dividends to the US shareholder.

In order to prevent a presumably unintended result like this, §245A needs to be amended to provide for no participation exemption for all non-active-business income earned during non-CFC-status years when distributed to US shareholders.

(While this writer has not yet attempted to think through this issue, as a foreign corporation during its non-CFC status years may have qualified as a PFIC, it would seem that there might need to be some provisions to coordinate PFIC, CFC, and participation exemption issues.)

7. New §1247 – Issues Concerning Sales and Exchanges

A. Limitation of participation exemption to intended foreign active business income

When a US shareholder sells or exchanges shares of a CFC, there may be gain from two components that should not receive the benefit of the new participation exemption. These two components are:

-- Any appreciation in assets owned by the CFC being sold (or by lower tier CFCs) that would create subpart F income if the owner-CFC were to sell or exchange such assets (e.g. property that gives rise to dividends, interest, royalties, rents, etc., see §954(c))

-- Any income of the CFC (or of lower tier CFCs) that has been protected from immediate subpart F inclusion through the §954(b)(3)(A) de minimis rule (This is consistent with the discussion above that covers the need for the §245A participation exemption to be limited so that the exemption will not apply to any CFC's income that is protected from immediate subpart F inclusion through the §954(b)(3)(A) de minimis rule. New §1247 must be similarly limited.)

The following comments concern how to accomplish this limitation in new §1247.

-- Regarding the first listed component concerning certain appreciated assets, provide for the normal corporate rate (25%) to apply to the US shareholder's gain on the sale or exchange of the CFC shares to the extent of that US shareholder's share of aggregate positive difference between the fair market values of the CFC's assets that would create subpart F income if sold by the CFC and their tax bases under US tax principles. Where the CFC being sold is itself the direct or indirect shareholder of one or more CFCs, then the calculation of the amount of this gain should

be made on a combined basis. The fair market value of assets should be determined as of the date of the US shareholder's sale or exchange of CFC shares.

-- Regarding the second listed component concerning CFC income that has been protected by the §954(b)(3)(A) de minimis rule, if (as suggested earlier herein) the §954(b)(3)(A) de minimis rule is completely eliminated, then no further adjustment would be necessary and all gain on sale (after reduction for amounts to be taxed at the normal corporate rate as described in the immediately preceding paragraph) would receive the §1247 participation exemption benefit. Note that if §961 is retained as suggested later in this submission (item 12), there will be an increase in basis for subpart F income included in a US shareholder's income under §951(a). As a result, there would be no gain recognized upon the sale or exchange of the CFC's shares to the extent of this previously taxed income. If §961 is deleted and there is no increase in basis, then the calculated tax under §1247 would be overstated. Such a result is inappropriate and is an important reason for retaining both §§959 and 961.

-- If the §954(b)(3)(A) de minimis rule is not eliminated, then any US shareholder gain on the sale or exchange of the CFC shares should be taxed at the normal corporate rate (25%) to the extent of the cumulative undistributed income that has been protected by the §954(b)(3)(A) de minimis rule within the CFC and any lower tier CFCs.

Note that existing deemed-paid foreign tax credit rules that now apply in the event of a §1248 transaction should apply as well to the extent that any foreign taxes paid relate to CFC income or assets causing normal corporate taxation (25%) on the US shareholder's gain.

Note additionally that once these changes are made, the 70% requirement for "qualified foreign corporation" status in §1247(b)(1) could logically be eliminated.

It is appropriate to add that if the above suggested changes are not made, then the present 70% percentage test should be raised to a much higher percentage (say, 95%) since this low 70% will allow many US shareholders to indirectly sell significant non-active-business assets and cumulative undistributed §954(b)(3)(A) de minimis rule protected income held within the CFC and be fully covered by the new §1247 participation exemption. This is simply not appropriate and will further encourage the movement of assets and income from the US into CFCs.

B. Coordination with worthless security deduction

New §1247 allows for a very low capital gain tax and no benefit from capital losses. To be consistent and not allow any losses to be deductible to the US shareholder, there needs to be an amendment to §165(g)(3) so that the US shareholder is denied a deduction for any worthless security loss of its CFC.

If this change is not made, then the ability to achieve an ordinary loss under §165(g)(3) will cause US shareholders of poorly performing CFCs to attempt to cause them to become insolvent rather than maximizing any perceived value through sale of the shares.

8. New §245A – Noncontrolled 10/50 Corporations – Foreign Tax Credit

This writer is scratching his head a bit over the treatment of non-electing domestic corporate shareholders of noncontrolled 10/50 corporations. In brief, where no election is made under new §245A(b)(1)(A), the tax results are:

- Full taxability to the US shareholder of dividend distributions at the 25% rate (i.e., no application of the participation exemption)
- No deemed-paid foreign tax credit as exists under current law for taxes imposed on the noncontrolled 10/50 corporation
- A §901 foreign tax credit for any foreign withholding or other taxes imposed on the US shareholder recipient of the dividend distribution

This new scheme results in double-taxation, as the following simple example shows.

		US Corp X Owns 40% of Y in Country B (Below numbers represent X's 40% share of Y's operations)	
		No §902 FTC	With §902 FTC
A	Y Revenue	1000	1000
B	Y Expenses	900	900
C	Y Net Income	100	100
D	Country B Tax imposed on Y 20%	20	20
E	US Tax before FTC at 25% imposed on X Tax base is dividend received by X from Y plus §78 gross-up in column 2	20	25
F	FTC Limitation	20	25
G	FTC Allowed	0	20
H	US Tax Payable by X (E - G)	20	5
I	Total Tax Obligation on X and Y (D + H)	40	25

As can be seen from the above, using these assumed numbers, the effective total tax burden rises to 40% where there is no deemed-paid foreign tax credit mechanism. Where there is such a mechanism, double-taxation is relieved so that the total tax burden is the higher of the US tax

rate or the foreign tax rate. In this example, as the US corporate is higher, the total tax burden is 25%.

If a US shareholder of a noncontrolled 10/50 corporation, for whatever reason, does not make the §245A(b)(1)(A) election, it seems very inappropriate to create double-taxation such as would occur in the first column.

Considering this, there appears to be two approaches that could deal with this obvious inequity.

- Continue §902 solely for such nonelecting noncontrolled 10/50 corporations
- Eliminate the §245A(b)(1)(A) election and make CFC characterization mandatory for all noncontrolled 10/50 corporations

This writer suggests that the first approach be used. A minority US shareholder may not have access to the information necessary to apply subpart F annually. Only when distributions are made will the US shareholder have to obtain information necessary to support any claimed deemed-paid foreign tax credit. And if the US shareholder is not able to obtain such information, then no foreign tax credit could be claimed.

If it is decided not to implement this first approach, then this writer suggests that the second approach be used under which CFC characterization would be mandatory. This appears to be the only other fair approach.

9. New §904(b)(3) – Indirectly Allocable Expenses – Erosion of Domestic Tax Base

This writer does not mean to be unduly cynical, but this amendment to the §904 foreign tax credit limitation seems like a lobbyist slipped someone a seemingly innocuous simplification that wouldn't attract much attention, but which would mean significant benefits to his clients.

Regarding the practical effect of new §904(b)(3), in brief, by eliminating any indirectly allocable expenses from the calculation of foreign source taxable income as used in the foreign tax credit (FTC) limitation formula, the calculated FTC limitation will be increased. Depending on the particular expense profile of the taxpayer, this increase may be large or small. For many US MNCs, this increase will be significant and will allow more foreign tax credits to be claimed, thereby reducing such taxpayers' US tax payable.

Broadly speaking, the policy goal behind the FTC limitation formula is to protect the domestic US tax base. The principle is that a US taxpayer will always pay US tax on his US source taxable income. By artificially increasing the FTC limitation through this elimination of any indirect expenses in the computation, the result for any taxpayer with excess foreign tax credits is to lower his US tax on his "real" US source taxable income.

To this writer, this amendment to §904 appears to be simply a unnecessary give-away of potentially a tremendous number of tax dollars. And it has no relationship at all to the principle

focus of this proposed legislation, which is to transition from a deferral system to a territorial system.

The only possible “policy” reason for considering this amendment would be that the FTC calculation is marginally simpler and the change would prevent some future arguments between the IRS and taxpayers on the proper allocation of indirect expenses.

It should be noted here that the IRS and taxpayers have been successfully living with indirect expense allocations for many many years. Further, even if such allocations were to be eliminated from the FTC limitation calculation under this proposed amendment, the tax rules would still include all the various indirect expense allocation rules since they are needed for other important taxation computations (e.g. the computation of subpart F income, the calculation of effectively connected income, etc.—see Treas. Reg §1.861-8(f)(1) for a long listing of operative sections for which these expense allocation rules remain fully applicable).

Clearly, any simplification to our complicated taxation system should be sincerely welcomed. However, to this writer, other “policy” reasons appear of much greater weight and concern. These other “policy” reasons include:

- The budgetary needs of our government—this is not a time to reduce our domestic tax base
- The fact that our income tax is intended to be a tax on net income—anything such as this amendment that would cause the tax after application of the FTC mechanism to veer from that result is not good tax policy
- Fairness amongst varying taxpayers—because of this amendment, where a purely domestic corporation and a US MNC with excess FTCs are conducting the same domestic US business and earning the same taxable income from that domestic business, this amendment will result in the domestic corporation paying more US tax than the US MNC would pay—such disparity between purely domestic and US MNC taxpayers is simply not good tax policy

For the various reasons discussed above, this new §904(b)(3) amendment should definitely not be made.

10. Deletion of §904(d) – Separate “Baskets”

From a simplification standpoint, eliminating the §904(d) “basket” rules would of course be one giant step for mankind...or at least something close to that. However, the economic reasons behind these rules have not gone away.

Whether speaking of individual taxpayers or corporate taxpayers, all will still have different types of foreign source income and they will plan their actions in order to allow maximum “cross-crediting” so that the FTCs generated by highly taxed foreign income may reduce the US tax on low or non-taxed foreign sourced income.

Good tax policy can of course allow some cross-crediting. Today's world of global investing, though, allows taxpayers easy avenues to choose to invest in ways that will generate foreign source income in place of domestic source income without being in a significantly different economic position. For example, taxpayers can choose to invest in shares of foreign corporations paying foreign source dividends instead of comparable US based public companies. Or, taxpayers can simply shift interest-earning bank deposits from their local bank down the block to a bank in Canada or some other country. Good tax policy does not encourage this behavior...and this is exactly what a complete elimination of §904(d) would do.

It may be added that purely domestic taxpayers that do not have excess foreign tax credits will not be able to shift assets and thereby reduce their US tax obligation using the above cross-crediting techniques. As such, deleting the §904(d) "basket" system would cause similarly situated domestic taxpayers to be paying relatively higher US tax than taxpayers with excess foreign tax credits who choose to shift assets and apply cross-crediting.

This writer strongly suggests that §904(d) be retained as it is. Any wholesale elimination of §904(d) would significantly reduce the US tax base at a time when the goal should be to expand it. Having said this, this writer does agree that a review of §904(d) for possible simplification is appropriate, but only subsequent to any changes that Congress makes to the overall taxation of foreign income (e.g. after changing the current deferral system to a territorial system). Only after any "system" change is made can a real review and analysis be made to determine what amendments to §904(d) are appropriate.

11. §909 – Repeal

Current §909 should be dealt with in a similar manner as that suggested in item 10 above for §904(d). As such, §909 should be retained and only reviewed for deletion or amendment subsequent to any changes that Congress makes to the overall taxation of foreign income (e.g. after changing the current deferral system to a territorial system). Only after any "system" change is made can a real review and analysis be made to determine whether deletion or amendment of §909 is appropriate.

12. §§959 and 961 – Elimination

Interestingly, as presumably a simplifying action, the proposed legislation eliminates both §§959 and 961 from subpart F despite the continued existence of subpart F and inclusions of subpart F income in the income of US shareholders under §951(a)(1)(A). In describing this change, the Technical Explanation states in part:

“...all distributions by a CFC to a 10-percent U.S. shareholder out of earnings and profits, *including amounts previously included in the 10-percent U.S. shareholder's income under subpart F*, are taxed as dividends potentially eligible for the [95]-percent dividends-received deduction...” (Emphasis added.)

This manner of describing this dividend income treatment for previously taxed income and availability of the 95% dividend-received deduction gives a surface impression that this is a

benefit to US shareholders. Rather, this is effectively an addition tax penalty for having earned tainted subpart F income since in addition to the subpart F income being full recognized as 25% taxable income in the hands of the US shareholder when such previously taxed income is later distributed, there will be an additional 1.25% tax.

This writer generally will not be bothered by a simplifying mechanism that potentially imposes a little extra tax as long as it's reasonably consistent with the theory or logic that underlies the tax. However, in this case, the logic behind the proposed territorial system and the use of a 95% dividend-received deduction to put it into effect is simply inconsistent with this proposed treatment.

Recall that the stated intention of the new participation exemption is to eliminate 100% of the US tax on foreign earnings. The reason for granting only a 95% dividend-received deduction rather than a 100% deduction is to provide an adjustment mechanism to disallow US shareholder expenses that are attributable to exempt foreign income.

Keeping this stated intention in mind, when subpart F income is recognized under §951(a)(1)(A), it is fully includible in income taxable at the 25% rate. As such, it is not exempt foreign income and all expenses attributable to that income should be fully deductible.

Despite this, the proposed legislation and Technical Explanation cause this income, which has been previously taxed to the US shareholder under the subpart F rules, to again be included 100% in income when distributed and then offset by only a 95% dividend-received deduction. Since there are no exempt foreign earnings for which we must disallow a portion of US shareholder expenses, the net 5% increase in taxable income is simply an inappropriate additional tax.

As indicated above in item 7A of this submission, there is also an inappropriate additional tax that occurs under new §1247 if §§959 and 961 are eliminated.

In order to correct the legislative language so the proper tax liability is achieved, it is recommended that §§959 and 961 be retained and appropriately amended to reflect the new participation exemption system. For example, the ordering rules could logically be changed to require that distributions be treated as first coming out of non-subpart F income (so that the 5% adjustment will fully apply) and only after such non-subpart F income is exhausted out of §959 previously taxed income.

In item 2 of this letter, there is a strong suggestion that the use of the dividend payment as a taxable event should be changed. If that were done, then this inappropriate result from the elimination of §§959 and 961 would not occur.

13. §1248 – Continued Application

Under the proposed legislation, §1248 would continue to be relevant for any sale or exchange of a CFC's shares (including noncontrolled 10/50 corporations electing CFC status under §245A) where either the holding period test or the 70% active assets test is not met.

It appears that certain changes made under the proposed legislation will perhaps unintentionally affect any sales or exchanges that remain under §1248.

First, §322(c)(7) of the proposed legislation eliminates §1248(d)(1), which presently provides that any undistributed previously taxed income under §951 is excluded from a foreign corporation's earnings and profits. With this change and with the elimination of §961, it appears that there will be a double inclusion of ordinary income with any §951 previously taxed income being again included as a dividend rather than as capital gain from the sale or exchange. As such, it appears that §322(c)(7) of the proposed legislation should be eliminated.

Second, with §902 being eliminated, there will no longer be any mechanism for the deemed paid credit that is necessary for §1248 to economically work properly. This needs to be corrected in some manner either by retaining portions or all of §902 or in some way expanding §960 to cover §1248 gain that is characterized as dividend income.

14. §960 – Effect of Elimination of §902

With §902 gone, the E&P pools of §902(c) are gone. How does that affect the calculations under §960? It is suggested that this be considered.

15. Option A – New category of subpart F income for intangibles

Definition of Covered Intangible

Regarding the covered intangible definition, it appears that the following situation would not be a covered intangible.

Say that a US MNC desires to purchase certain intangibles. Such a purchase could be either a simple purchase of intangibles or as part of an acquisition of a target that owns intangibles. The US MNC and the seller arrange that a CFC wholly owned by the US MNC will acquire the intangibles directly from the seller or from the target as a step in the acquisition of the target.

Following the acquisition, the CFC as owner of the intangibles licenses them to various US MNC group members around the world, including the US shareholder and other domestic group members. As the CFC wholly owns the intangibles and fully bears all costs related to them, there is no need for any shared risk or development agreement.

Under the presently proposed definition of covered intangible, it appears that this situation would not create a covered intangible. Because the US shareholder has full control (subject of course to negotiating the acquisition's structure with the seller) over where within the group the intangible

ownership will be, there is some logic that such a situation should constitute a covered intangible subject to this new foreign base company excess intangible income.

Consideration should be given to whether the definition of covered intangible should be broadened to include this type of situation.

Need for Presumption that §936(h)(3)(B) Intangibles Have Been Used

Transactions will only be includible as foreign base company excess intangible income if covered intangibles are “used directly or indirectly” in the relevant sales, services, etc. Tax authority auditors will clearly have great difficulty identifying §936(h)(3)(B) intangibles used where a US shareholder maintains that there are only normal business intangibles (e.g. goodwill) and therefore does not voluntarily include such transactions in the foreign base company excess intangible income calculation.

Because of this near impossibility for tax authority auditors to properly audit this new foreign base company excess intangible income category, there must be a presumption that all of a CFC’s sales, services, etc. will be treated as foreign base company excess intangible income unless the taxpayer is able to establish otherwise. This may create some additional administration, but it is the only way to give this provision real teeth.

Applicable Percentage

The 10% to 15% range for phasing out this new foreign base company excess intangible income is too low.

Just as many groups have structured non-US intangible ownership so that there’s little or no tax on their intangible income, they should also be able to structure ownership resulting in taxation close to the 15% cut-off point. And they will work hard to achieve such taxation given the significant difference between (i) a 15% foreign tax plus a US tax of 1.25%, (which will likely be deferred and maybe never paid) and (ii) the 25% tax that would result from subpart F classification.

Tax policy should attempt to discourage this sort of game playing that simply benefits some jurisdiction that is happy to impose a 15% tax. As such, this writer suggests that the existing and well-known standard of §954(b)(4) be used (i.e. the effective tax rate being over 90% of the maximum §11 rate, which would be taxation in excess of 22.5%). For simplicity, with this higher level of 22.5%, there’s no need for the presently proposed phase-out that occurs between 10% and 15%.

16. Option B – New Low-Taxed Cross-Border Foreign Income

The 10% rate is too low. The same comments generally apply as those made under the Applicable Percentage heading in above item 15 on the new §331A that deals with excess income from intangibles. As such, to discourage game-playing that simply benefits some

jurisdiction that is happy to impose a 10% tax, the §954(b)(4) standard should be used in place of 10%.

This writer expected to see included in new §952(c)(2)(C) a clause that provides that acceptable activities include manufacturing by the CFC within the country of incorporation of products, whether consumed locally or exported. Presently, only locally consumed products sales are included.

Perhaps this lack of local manufacturing is because of a policy concern that such an exception might encourage the export of jobs from the United States. For many valid business reasons (logistical, labor costs, proximity to raw materials, etc.), there are many many cases of manufacturing within one country with much of the production being exported to other countries. If “job exporting” from the United States is the concern, then this writer suggests that there be a carve out (and thus subpart F treatment) to the extent that a CFC manufactures products in its country of incorporation for export to the United States.

To summarize, this writer suggests that local manufacturing be added to new §952(c)(2)(C). And, if deemed necessary, that there be the above-mentioned carve-out to the extent that products are sold for consumption, use, or disposition in the United States. It may be added that there is plenty of existing guidance on manufacturing that can be used that is found in the regulations under the foreign base company sales income provisions.

This writer recognizes that this Option B does not make any allowance for potentially legitimate branch operations, such as are currently dealt with by the §954(d)(2) branch rule. And this writer agrees with this approach. It is reasonable to deal with this simply through the proposed minimum effective tax rate proscribed in new §952(e)(1)(B). Again, game-playing with branches is another reason to increase the proscribed rate from 10% to the suggested §954(b)(4) standard.

17. Option C – New Foreign Intangible Income

To this writer, Option C should be dropped immediately like a hot potato for several reasons.

First, it would create a nightmare of subjective and miserable-to-resolve valuation questions between taxpayers and the US tax authorities. The definition of “intangible income” in new §954(f)(2) appropriately reads, in part: “...to the extent that such gross income is properly attributable to such intangible property...”. Thus, this is not an all or nothing situation where 100% of the income from a qualifying transaction will receive the 40% deduction. Rather, the income from each qualifying transaction will have to be split between the portion attributable to §936(h)(3)(B) intangibles and the portion that is from other business factors. Recall that §936(h)(3)(B) does not include goodwill or going-concern value. Such splitting requires Solomon-type judgment that will keep our courts and judges occupied for a long time.

Second, this Option C appears to be a gift to every US MNC that likes to “play games”. And that’s a pretty high percentage of the universe of US MNCs. In addition to pushing the envelope with regard to subjective valuation issues, the in-house tax personnel within US MNCs and their

advisors will spend considerable time and effort scrubbing each manufacturing, sales, service, and other relevant operation to identify all the previously unidentified §936(h)(3)(B) intangibles...previously unidentified because there had been no reason to identify them. So, for example, they will look for workforce-in-place intangibles and internally produced processes, patterns and know-how as well as technical data and some marketing intangibles. To further substantiate both the existence of these items as well as document them, they may as well execute inter-company license agreements to provide more visible royalty flows.

All of this effort will provide perhaps convincing looking paperwork, but it will be a lot of effort focused solely at reducing the US MNC's effective tax rate and will not be otherwise economically productive. In the absence of this Option C, none of this analysis and document execution would have been undertaken.

It of course should be added that all this activity will only reduce the US tax base.

Will this 40% deduction encourage more domestic corporations and US MNCs to expand their efforts to increase foreign sales and services? Perhaps, but any potential benefit is simply not worth the pain and bad tax policy that this creates.

Another point to add is that a tax policy that is meant to influence the adoption of new behavior (i.e., increased effort to expand export sales and services) should not be rewarding all the existing behavior that taxpayers are conducting without any governmental encouragement. Rather, it should reward only the increases. Thus, if this idea goes further, some mechanism would need to be developed to reward only the increases and not the existing base.

In summary, Option C is a terrible idea; it would not be wise to go down this road.

As a final point, or perhaps more correctly, as a final question, this writer notes that some of the language used in this Option C is similar to that previously used in the DISC, FSC, and ETI export incentives. The one significant difference appears to be the absence of any maximum limit on the portion of value that can come from articles manufactured, produced, grown or extracted outside the US or from labor performed outside the US. Not being knowledgeable of the GATT and WTO cases against these former US export incentives, this writer has no idea whether this difference is enough to fully prevent any new challenges. Given the energy, though, that our trading partners have expended in reviewing our export incentives, it would be helpful to have this issue directly addressed and explained within the Technical Explanation.

18. Which of the Three Options Should Be Used?

If the Option B safe harbor rate is increased to the §954(b)(4) 90% of the maximum §11 rate (22.5%), this writer sees that as the best.

If this Option B safe harbor rate is not increased, then Option A is acceptable, especially if the changes recommended above are made.

Option C should not be considered at all.

* * * * *

I would be please to respond to any questions that you might have.

Yours very truly,

A handwritten signature in black ink, appearing to read "JK Kadet". The signature is fluid and cursive, with the first part being a stylized monogram and the last part being the surname "Kadet".

Jeffery M. Kadet

c.c. The Honorable Sander Levin
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**Written Submission of the RATE Coalition
Submitted November 17, 2011
Committee Ways and Means
Subcommittee on Select Revenue Measures**

In today's global economy, America's tax system must reflect the dynamic and innovative marketplace in which all businesses compete. Reducing America's Taxes Equitably (RATE) is a coalition of businesses, associations and other like-minded groups that have joined together to advocate for sound and equitable reforms to the tax code that will restore the competitiveness of the United States as a place to invest and grow, and boost job creation and economic growth.

The 24 members of RATE employ over 30 million people across all 50 states and support innumerable suppliers and small businesses. RATE believes that in order to improve the prospects of growth and jobs in the American economy, the U.S. must reform the corporate tax code, making it fairer and simpler, and lower the 35 percent statutory corporate income tax rate to make it more competitive with America's major trading partners.

RATE was therefore encouraged that the Ways & Means Committee's recent tax reform proposal from Chairman Camp advocated for a 25 percent corporate tax rate. The coalition believes that this lower rate will justify itself via increased economic growth and job creation – and that it is imperative for the U.S. to act now. The coalition also believes that corporate tax base-broadeners should be examined if necessary to achieve a more equitable and competitive corporate tax system.

Today, the U.S. tax system has become an outlier relative to other advanced economies in terms of a significantly higher corporate rate. Over the last two decades, most other developed nations have reduced their statutory corporate rate. Of the 34 OECD nations, 30 have lowered their statutory corporate income tax rates since 2000. Additionally, the United Kingdom is scheduled to lower its rate to 23 percent by 2015, while Canada's federal rate is 16.5 percent with a reduction to 15 percent in 2012. There is an ongoing international competition between countries for the most favorable corporate tax system and the U.S. is clearly losing.

In 2010, the average corporate tax rate in the OECD (excluding the U.S.) was 25.5 percent, including sub-central taxes. In contrast, the corporate tax rate in the United States stands at over 39 percent once state and local taxes are accounted for. This system puts U.S. companies at a competitive disadvantage and hinders economic growth.

In fact, a 2008 report by economists at the OECD found that the corporate income tax is *the most* harmful tax for long-term economic growth. This is because capital and income are the most mobile factors in the global economy and, thus, the most sensitive to high tax rates. Research generally finds

that foreign direct investment (FDI) is highly sensitive to cross-country differences in after-tax returns. One study summarizing the research found that a one percentage point reduction in a host country's tax rate increased FDI by 2.9 percent and also found that the responsiveness of FDI has risen over time. Additionally, because capital is mobile but workers are not, labor bears a disproportionate share of the burden of corporate taxes – as much as 75 percent by some estimates.

Reducing the statutory rate, therefore, will provide several benefits to the U.S. economy. As a recent paper commissioned by RATE and published by Ernst & Young highlighted, benefits of a lower corporate income tax include:

- Increased competitiveness of the United States in the global economy;
- Increased capital investment in the United States;
- Increased employment and living standards for Americans; and
- Reduced impact of taxes on economic decisions.

Thus, a significant corporate tax rate reduction is needed to both help U.S. companies compete abroad and attract investment in the United States by foreign companies. Specifically, a more competitive rate will increase capital investment, bringing more employment and higher wages for U.S. workers, as well as higher living standards. Investment will also translate into increased U.S. production at home and expanded exports to the rest of the world.

While the benefits cannot be predicted with precision, many studies support the finding that a reduction in the corporate tax rate will spur faster economic growth and create jobs in the U.S. According to the Heritage Foundation, reducing the corporate tax rate to 25 percent will create an average of 581,000 jobs in the U.S. annually from 2011 to 2020. The Milken Institute also published a study indicating that if the U.S. moved to the average OECD rate it could boost GDP by 2.2 percent and increase employment by 2.13 million workers. Lee and Gordon in the *Journal of Public Economics* report similar numbers, finding that a reduction in the corporate rate by ten percentage points will lead to GDP growth of between 1-2 percent.

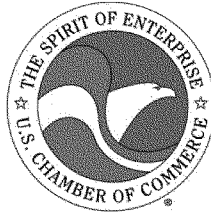
Studies also find that lower rates have benefited America's competitors. According to Ernst & Young, between 2000 and 2011, the two countries with the highest corporate income tax rates (the U.S. and Japan) suffered a net loss of 46 and 39 Fortune Global 500 company headquarters, respectively. The firm also finds that in the last few years, European corporate taxable income expanded by 0.45 percent for every one percent decrease in the statutory corporate income tax rate.

Finally, economic growth creates successful companies, and successful companies create more jobs and pay better wages. Studies show that American workers and families will also benefit from a lower tax rate. According to the American Enterprise Institute, data from 65 countries over 25 years show that every one percent increase in corporate tax rates leads to a 0.5-0.6 percent decrease in wages. Ernst & Young has also found that workers bear up to 75 percent of the burden of the corporate income tax. In the U.S., this equates to lower wages and benefits of \$100 - \$200 billion at the average level of corporate taxes between 2000 through 2010. Reducing the statutory rate to 25 percent, according to the Heritage Foundation will actually increase a family of four's after-tax income by \$2,484 annually, on average.

In summary, a lower, more competitive corporate tax rate, in line with the proposal from Chairman Camp, will better allow U.S. businesses to compete in today's globalized marketplace while making the U.S. a more attractive place to invest and create jobs, benefiting American workers, American consumers and American small businesses.

About RATE Coalition:

RATE is a coalition of 24 companies and organizations advocating for sensible corporate tax reform. Making the tax code fairer and simpler will help spur job growth and stimulate the U.S. economy and make us more competitive globally. RATE members currently include: AT&T, Altria Client Services Inc., Association of American Railroads, Boeing, Capital One, Cox Enterprises, CVS Caremark, FedEx, Ford, General Dynamics, Home Depot, Intel, Lockheed Martin, Macy's, National Retail Federation, Nike, Raytheon, Texas Instruments, Time Warner Cable, T-Mobile, UPS, Verizon, Viacom and Walt Disney. More information about the coalition is available at www.RATEcoalition.com



Statement Of the U.S. Chamber Of Commerce

ON: **Hearing on Ways and Means International Tax Reform
Discussion Draft**

TO: **Subcommittee on Select Revenue Measures, House Committee on
Ways & Means**

DATE: **November 17, 2011**

The Chamber's mission is to advance human progress through an economic,
political and social system based on individual freedom,
incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business -- manufacturing, retailing, services, construction, wholesaling, and finance -- is represented. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 115 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. More than 1,000 business people participate in this process.

INTRODUCTION

The Chamber thanks House Subcommittee on Select Revenue Measures (the Subcommittee) Chairman Tiberi for requesting feedback on the international tax reform discussion draft (the Discussion Draft) released on October 26, 2011 by the House Committee on Ways and Means. While the Chamber applauds the transition to a territorial system of taxation, we have initial concerns over certain aspects of the draft that are articulated below. We are continuing our analysis of the Discussion Draft and how it compares to other countries' territorial tax regimes, and we will supplement these initial comments as appropriate.

A BRIEF NOTE ON FUNDAMENTAL TAX REFORM AND PROPOSED RATE STRUCTURE

The Chamber supports fundamental tax reform and, thus, believes tax reform should be comprehensive and should address both the corporate and individual sides of the Code.¹ The Chamber appreciates that the Discussion Draft proposes to lower both corporate and individual tax rates to 25 percent. The Chamber, however, reserves further comments on the proposed rate reductions until additional details are provided with respect to the corresponding base broadening measures that will be proposed.

TRANSITION RULE FOR UNREPATRIATED FOREIGN EARNINGS

The Discussion Draft provides that U.S. shareholders owning 10% or more of the stock of a foreign corporation include in income all pre-effective date, unrepatriated earnings of such foreign corporations. This deemed repatriation applies regardless of whether the unrepatriated earnings are actually distributed to the U.S. shareholders.

Earnings that are not actually distributed by the foreign corporation will be subject to an additional 1.25% tax when subsequently distributed (assuming the distribution qualifies for the new 95% dividends received deduction).

The Chamber seeks to better understand the purpose of this transition rule and determine whether the transition rule is tailored to such purpose. If this transition rule can be narrowed, it should be. As currently drafted, the Chamber has the following concerns:

- Not all unrepatriated earnings are liquid. Thus, we believe that the Committee should consider, for example, exempting from the provision unrepatriated earnings that have been reinvested in plant, property, and equipment.
- The deemed repatriation provision appears to apply to domestic pass-through entities. The Chamber is concerned that pass-through entities are part of the “pay for” to achieve revenue neutrality in the new regime without a corresponding benefit. In this regard, the pass-through entity would not be eligible for the new 95% dividends received deduction.

¹ All references to the Code are to the Internal Revenue Code of 1986, as amended, and the Treasury regulations promulgated thereunder.

FOREIGN TAX CREDIT CHANGES

The Discussion Draft repeals the credit for deemed paid foreign taxes under Code section 902 that is available to a U.S. corporation that owns 10% of the voting stock of a foreign corporation. The Discussion Draft replaces the credit with a 95% dividends received deduction for the foreign source portion of dividends received from the foreign corporation.

This new participation exemption system applies only to U.S. C corporations. U.S. persons other than U.S. C corporations, including S corporations and other pass-through entities, are not eligible for the new participation exemption system. The Chamber urges the Committee to carefully consider the impact that the Discussion Draft would have on the tax treatment of distributions received by domestic pass-through entities from their foreign subsidiaries.

RETENTION OF SUBPART F

The Discussion Draft retains the Subpart F regime, not only for passive income but also for certain active earnings that are treated as Subpart F income. The Discussion Draft, however, eliminates the Code Section 959 exemption for distributions of previously taxed income.

Under the proposed participation exemption regime, all active foreign earnings, including active earnings that have been previously taxed at the regular rates under Subpart F, will be subject to an additional 1.25% tax when distributed. Thus, active earnings that have been previously taxed under Subpart F will be subject to double taxation.

The Chamber believes the Committee should consider amending Subpart F to apply only to passive income.

BRANCHES TREATED AS CFCs

Under current law, unincorporated foreign branches are simply extensions of the U.S. corporation, as opposed to being separate legal entities. A branch's foreign earnings represent foreign source income earned directly by the U.S. corporation and are subject to U.S. tax at the regular corporate rates, with a corresponding foreign tax credit (subject to the applicable foreign tax credit limitation). Conversely, the U.S. corporation can deduct the foreign losses of a branch against its U.S. profits.

The Discussion Draft treats all foreign branches as controlled foreign corporations (CFCs) but does not explain the policy reason behind this change. It would be helpful for the Committee to provide further explanation of the policy reasons for the proposal so that U.S. corporations may conduct a more thorough analysis of the proposal and offer alternative recommendations if appropriate.

Because the Discussion Draft treats foreign branches as CFCs, they will fall within the participation exemption system, and their earnings will therefore be eligible for the 95% dividends received deduction. Thus, distributions made by the branch from its foreign earnings

to the U.S. corporation will be taxed at an additional maximum rate of 1.25%. No foreign tax credits would be available to offset the taxable 5% of the distribution.

Most OECD countries that allow less than a 100% participation exemption regime nevertheless allow a 100% exemption for branches. Accordingly, the Chamber believes the Committee should consider applying a 100% participation exemption system for foreign branches of U.S. corporations as well.

PREVENTION OF BASE EROSION – CHANGES TO SUBPART F

The Discussion Draft includes three alternative Subpart F categories that are intended to prevent base erosion under the participation exemption system.

The Chamber questions the need for any of these alternatives, since other countries that have switched to participation exemption systems do not appear to have experienced base erosion.

The proposed new categories of Subpart F income apply to all U.S. shareholders, whether or not they are eligible for the dividends received deduction. Thus, S corporations and other pass-throughs would be subject to these provisions, even though they do not qualify for the 95% dividends received deduction.

We believe each of these alternatives would reduce the competitiveness of U.S. companies. If needed at all, more time should be spent further developing these alternatives and narrowing their impact so as only to affect the activity intended to be discouraged. The Chamber is continuing to review these proposals and will provide additional feedback at a later date. In the interim, however, we offer the following initial comments on the proposals.

NEW SUBPART F CATEGORY – OPTION A

Under Option A, excess income from transfers of covered intangibles to low-taxed CFCs (foreign effective tax rate of 10% or less) is treated as Subpart F income. Excess income is defined as income connected with the transferred intangible in excess of 150% of the costs (excluding interest and taxes) attributable to such income.

The Chamber is concerned that this provision has been drafted in a manner that is overbroad. First, the Chamber believes that the definition of “covered intangible” is overbroad. A covered intangible could arise, for example, from a CFC to CFC cost sharing arrangement to which no related U.S. person has provided any intangible property – i.e., there has been no potential base erosion due to the outbound migration of intellectual property. Second, the Subpart F treatment applies when a covered intangible is used directly or indirectly in the property giving rise to the income. Using the word “indirectly” may be overbroad.

NEW SUBPART F CATEGORY – OPTION B

Option B would treat as Subpart F income a CFC's earnings that are not derived from an active trade or business in its home country nor subject to an effective foreign tax rate of at least 10%.

This alternative is troubling since it may subject corporate structures with significant substance in terms of people and business activity in low taxed countries to a higher level of taxation. The Chamber believes the focus should more properly be upon structures without substance consistent with business operations.

NEW SUBPART F CATEGORY— OPTION C

Option C creates a new category of Subpart F income for income from the sale of goods or services attributable to intangible property without regard to where the intangible is developed or exploited, resulting in global taxation of income resulting from the use of intangibles. This income, as well as intangible property-related income earned directly by U.S. corporations, would be taxed at a rate of 15% (as modified by the Subpart F high-tax exception).

Under this alternative, intangible property income earned by a foreign affiliate would be subject to an additional 1.25% tax when repatriated (assuming it qualifies for the 95% dividends received deduction). Further, it will be difficult for companies to determine what portion of foreign income is deemed attributable to the exploitation of intangible property.

PREVENTION OF BASE EROSION: THIN CAPITALIZATION RULES

The Discussion Draft includes a provision to limit deductions for net interest expense of U.S. corporations to discourage them from borrowing in the United States to finance overseas operations that may be eligible for the 95% dividend exemption. The provision disallows interest incurred by U.S. groups where the U.S. debt level exceeds the global debt level, or if debt exceeds an unidentified financial ratio.

The Chamber believes that it is important to ensure that the financial ratio takes into account business cyclicity. Moreover, there are many non-tax reasons why U.S. companies need more funding in the United States than the debt ratio would predict. For example, most U.S. companies incur a large percentage of their research and development expense in the United States. If a company is expanding in the United States, it may be appropriate to have a higher level of debt to fund new projects. The Chamber believes the proposed thin capitalization rules should take these considerations into account.

OTHER ISSUES

As with corporations, the United States has long taxed the foreign-earned income of its citizens residing abroad, resulting in double taxation and disincentivizing the hiring of U.S. citizens. Studies have shown that U.S. expatriates employed as managers in foreign affiliates of American worldwide companies are a powerful driver of U.S. exports. No other country taxes its citizens working abroad, and the any transition to a territorial tax system should take this into consideration and end this damaging practice.

CONCLUSION

The Chamber thanks the Subcommittee for the opportunity to comment on the international tax reform Discussion Draft. The Chamber believes that as the Subcommittee and Committee consider fundamental tax reform, it is imperative to shift to a territorial tax system but that system must not be overly onerous to companies seeking to grow, compete, and innovate. We look forward to continuing discussions on this Discussion Draft and working with the Committee and Congress on this vital issue.