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Memorandum

DATE: April 12, 2013

TO: The Honorable Devin Nunes
United States House of Representatives

The Honorable Earl Blumenauer
United States House of Representatives

RE: Taxation of Non Corporate Shareholders of
Controlled Foreign Corporations under
Proposed Territorial Tax System

Recent territorial tax system proposals take the form of a dividend exemption system that exempts from U.S. taxes dividends (or a percentage of dividends) repatriated to U.S. corporations from their controlled non-U.S. subsidiaries ("CFC"); thus exempting such income from U.S. tax to the extent of the dividend exemption. The dividend exemption is achieved through a dividends received deduction. All of the territorial tax system proposals apply only to corporate structures; none apply to individual shareholders of non-U.S. subsidiary corporations. A territorial tax system should provide a comparable exemption from income for earnings distributed by a CFC to individual or pass-through 10% U.S. shareholders.

The movement to a territorial tax system is central to the debate of comprehensive tax reform. Implementation of a territorial tax system would be superior to the current hybrid system in terms of efficiency, simplicity and revenue. On October 26, 2011, Chairman Camp released an international tax reform discussion draft that transitions the United States from a worldwide system of taxation to a territorial system of taxation (the "Camp Discussion Draft").

The vast majority of businesses in the United States are organized for tax purposes as sole proprietorships. In 2009, there were more than 22.6 million nonfarm sole proprietorships out of 33.6 million total business returns. There were approximately 1.7 million C corporations, 1.9 million farms, 3.1 million partnerships, and 4.1 million S corporations. The number of passthrough entities surpassed the number of C corporations in 1987 and has nearly tripled since then, led by growth in small S corporations (those with less than $100,000 in assets) and limited liability companies taxed as partnerships. "Selected Issues Relating to Choice of Business Entity" JCX-20-12 March 5, 2012.

In today's global economy, non-U.S. subsidiary corporations are utilized by large and small corporate and non corporate U.S. taxpayers to conduct business activities abroad. If a territorial system is adopted, it should apply to all shareholders of non-U.S. corporations and not be limited to corporate shareholders of non-U.S. corporations.

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Current law

In general, U.S. corporations and U.S. individuals pay current tax on their worldwide income. However, if the individuals or corporations conduct their overseas operations through a foreign subsidiary corporation, the foreign corporation's business income generally is not subject to U.S. tax until the income is brought back to the U.S. (typically as a dividend). This ability to defer tax applies even if the income is earned by a CFC.

The ability to defer tax on non-U.S. income is subject to several exceptions. One such exception (under Code section 956), which dates back to 1962, requires U.S. shareholders of a CFC to pay tax on CFC earnings that are invested in "U.S. property." For this purpose, "U.S. property" includes a loan to a related U.S. person. Therefore, a shareholder of the CFC who borrows funds from the CFC pays tax on the entire principal amount borrowed.

Camp Discussion Draft

The principal provisions of the Camp Discussion Draft do not apply to non-corporate U.S. shareholders of a CFC. However, the Camp Discussion Draft contains a transition rule which applies to all U.S. shareholders (corporate and non-corporate) of a CFC. As a result (and as discussed below), non-corporate U.S. shareholders are subject to U.S. tax on earnings of a CFC “deemed” repatriated to the U.S. and then the same non-corporate U.S. shareholders are subject to U.S. tax again when the same earnings are actually distributed by the CFC.

The Camp Discussion Draft largely retains subpart F of the Code and implements the proposed territorial system by providing a dividends received deduction equal to [95] % of foreign-source dividends received by a 10% U.S. *corporate shareholder* of a CFC. As indicated, the Camp Discussion Draft does not provide a similar deduction for dividends received by non-corporate shareholders of a CFC.

A transition rule requires that a U.S. shareholder of a CFC currently include in income all undistributed, non-previously taxed foreign earnings, whether or not such earnings are repatriated. These earnings are taxed at a reduced rate through a deduction equal to [85] % of the required income inclusion. The transition rule applies to both corporate *and* non-corporate U.S. shareholders of a CFC.

The Camp Discussion Draft also repeals Section 959 of the Code, which excludes from gross income previously taxed earning and profits. Consequently, all distributions by a CFC to a 10-percent U.S. shareholder out of earnings and profits are taxed as dividends potentially eligible for the dividends received deduction described above.

The required income inclusion of all non-previously taxed foreign earnings combined with the repeal of Section 959 results in immediate taxation to non-corporate U.S. shareholders of a CFC. However, because the dividends received deduction applies only to corporate shareholders, if the shareholder of a CFC is an individual or pass through entity, the foreign earnings taxed as a result of the transition rule will be taxed again when the earnings are distributed as a dividend to the non-corporate U.S. shareholder of the CFC.

Recommendation

The application of a territorial system should not be dependent on the entity classification of the U.S. shareholder of a CFC. The policy justifications for a territorial system apply to both corporate and non-corporate shareholders of CFCs. The core provision of the territorial system – a dividend exemption system that exempts from U.S. taxes dividends (or a percentage of dividends) distributed to U.S.

shareholders from a CFC- should apply to all U.S. shareholders (corporate and non-corporate) of a CFC. In addition, any tax system should not result in double taxation of non-U.S. earnings distributed by a CFC to non-corporate shareholders of the CFC.

Alternative to Territorial System

Under the current subpart F regime, companies with active non-U.S. operations are encouraged to keep those operations outside the United States. The current system also encourages retention of the earnings of such business operations outside the United States and imposes a toll charge to invest such earnings domestically. Short of adopting a territorial system for all shareholders (individuals, partnerships and corporations) of a CFC, revisions to the current subpart F rules should remove the barriers to investment of non-U.S. earnings in U.S. property. Such rule would preserve the taxation of such non-U.S. earnings upon the repatriation of the earnings by a CFC, while providing capital for current investment in the U.S..

The IRS has issued guidance which provides that borrowed funds will not be considered "U.S. property" if (i) the borrowed funds are collected within 30 days of the time the debt is "incurred" and (ii) the CFC does not hold obligations that would otherwise be considered "U.S. property" for 60 days or more during the taxable year (i.e., the 30/60 rule). In response to liquidity concerns, the IRS in 2008 temporarily liberalized the rule to allow for obligations that are collected within 60 days of being incurred (as opposed to 30 days). The IRS has since twice extended this relief (in 2009 and 2010).

Proposal

In order to attract capital to U.S. business to stimulate the economy, for a limited time after enactment, U.S. shareholders (corporate and non-corporate) should be permitted to borrow from their non-U.S. subsidiaries without incurring U.S. tax. The allowed term of the loan should be 8-10 years, to match the typical intended time horizon to pay back the investment without providing a permanent exemption for repatriation. The use of the proceeds could be targeted for specified domestic investment and capital formation activities, including source funding for research and development expenses, expansion of facilities, early stage venture capital investment, manufacturing start-up costs, real estate investments, and U.S. energy and technology investments.

This liberalization of the restrictions on borrowing would facilitate capital investment in the United States while preserving an ultimate U.S. tax upon repatriation of the earnings.

We appreciate the opportunity to provide comments to the working group on international tax reform, and particularly the impact of recent proposals on non-corporate taxpayers. Please contact me if I can provide further information on these issues.