SUBMISSION TO

COMMITTEE ON WAYS AND MEANS

COMMENTS PRESENTED TO
THE INTERNATIONAL TAX REFORM WORKING GROUP

MARCH 3, 2013

THE FOLLOWING IS ATTRIBUTABLE TO

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Organization N/A

[redacted]

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**[Comments originally submitted on November 13, 2011
to the Committee on Ways and Means]**

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[redacted]

[redacted]

March 3, 2013
[Originally Submitted 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 wirter’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.

<u>Detailed Discussion of Issues and Recommendations</u>

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 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%).

<u>How to Change the Presently Proposed Legislation</u>

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 <u>Report on the Attribution of Profits to Permanent Establishments, Parts I, II, and III,</u> 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. <u>Limitation of participation exemption to intended foreign active business income</u>

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 of 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 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 not 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

<u>Definition of Covered Intangible</u>

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.

<u>Need for Presumption that §936(h)(3)(B) Intangibles Have Been Used</u>

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.

<u>Applicable Percentage</u>

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(e)(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(e)(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.

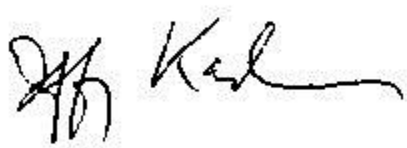
If this Option B safe harbor rate is not increased, then Option A is acceptable, especially if the changes recommended above are made.

Option C should not be considered at all.

*   *   *   *   *   *

I would be please to respond to any questions that you might have.

Yours very truly,



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