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]

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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.