S CORP

DEFENDING AMERICA'S SMALL AND FAMILY-OWNED BUSINESSES

April 15, 2013

The S Corporation Association Comments to the House Committee on Ways and Means International Tax Reform Working Group

The S Corporation Association commends the House Committee on Ways and Means (the "Committee") and the International Tax Reform Working Group for their commitment to comprehensive tax reform that would lower top tax rates for individuals and employers. We particularly appreciate the Committee's willingness to be transparent in this process and the opportunity to weigh in on these matters.

The comments below should be viewed as a friendly effort to recommend areas where we believe the international tax reform discussion draft (the "Discussion Draft") could be improved to ensure that Subchapter S corporations are not subject to double taxation.

Analysis

The Discussion Draft proposes to replace the current worldwide system of taxation with a territorial system, whereby under Section 301, certain 10 percent U.S. shareholders are entitled to a 95 percent dividends received deduction ("DRD") from dividends paid by controlled foreign corporations ("CFCs") out of undistributed foreign earnings. It is our understanding, consistent with the Committee's intention, that the DRD is limited to Subchapter C corporations and that, therefore, Subchapter S corporations with CFCs are not entitled to this deduction.

Despite the fact that Subchapter S corporations are not entitled to the DRD, a number of proposals in the discussion draft designed as transition and/or anti-abuse rules related to the DRD are potentially applicable to Subchapter S corporations (i.e., such proposed rules are not dependent on a corporation's eligibility for the DRD). The net effect of the potential application of these rules is to subject the income of Subchapter S corporations to double taxation without the benefit of the DRD to mitigate such double taxation.

Potential Application of the Deemed Repatriation Provision and the Repeal of the PTI Exclusion

For example, it appears that the deemed repatriation provision (Section 303) and the repeal of the so-called previously taxed income ("PTI") exclusion (Section 322) potentially apply to all taxpayers, including in particular Subchapter S corporations, regardless of their eligibility for the DRD. As a result, the income of Subchapter S corporations would be subject to double taxation in at least two instances:

(i) Pre-enactment income of CFCs would be taxed once as a result of the deemed repatriation provision and again upon actual distribution in light of the repeal of the PTI exclusion, and

(ii) Post-enactment income of CFCs would be taxed once under the new modified subpart F regime and again upon actual distribution in light of the repeal of the PTI exclusion.

805 15TH STREET, NW SUITE 650 • WASHINGTON, DC 20005 • PHONE: (202) 466-8700 • FAX: (202) 466-9666
WWW.S-CORP.ORG

In each case, there would be no DRD to mitigate the resulting double taxation. The result is inappropriate "cross subsidizing" where the Discussion Draft effectively raises taxes on Subchapter S corporations in order to finance the DRD benefit for C corporations.

Since the deemed repatriation is effectively a transition rule to, or "toll charge" for, the DRD, we believe it should not be applied to Subchapter S corporations given that they do not benefit from the DRD.

Instead, the deemed repatriation provision should only apply to taxpayers who are eligible for the DRD. To address any concerns that a Subchapter S corporation could restructure as a Subchapter C corporation after the legislation's effective date in order to avoid the deemed repatriation provision but take advantage of the DRD, the Discussion Draft could be amended to provide that the deemed repatriation provision would apply at the time of such conversion. Furthermore, as a general preventative measure, the Internal Revenue Service should be given general anti-abuse regulatory authority to address abusive situations where appropriate.

Treatment of All Branches as CFCs

The Discussion Draft also appears to treat all foreign branches of Subchapter S corporations as CFCs. Many Subchapter S corporations conduct their international operations through branches because current law treats Subchapter S corporation shareholders differently. Individual shareholders of Subchapter S corporations are eligible for the Section 901 direct foreign tax credit, but not the Section 902 indirect foreign tax credit.

Treating all foreign branches of Subchapter S corporations as deemed CFCs would result in double or even triple taxation of the same income. Subchapter S corporations are not eligible for the DRD so they would be incentivized to defer U.S. tax on foreign income, much like Subchapter C corporations are under current law. Upon repatriation of these earnings from deemed CFCs, however, Subchapter S corporation shareholders would be subject to U.S. tax without any relief for foreign taxes paid, since they are not eligible for the Section 902 indirect foreign tax credit.

Furthermore, any subpart F income of deemed CFCs of Subchapter S corporations could be subject to triple taxation – foreign tax when earned, U.S. tax when earned under the subpart F rules (with no Section 902 indirect foreign tax credit), and U.S. tax again upon repatriation (with no relief from the DRD or the repealed PTI exclusion).

In order to address this problem, we request the rule requiring all branches to be treated as CFCs should apply only to those corporations that are eligible for the DRD.

Potential Application of the "Base Erosion" Rules

In order to address the increased incentive to shift income to foreign jurisdictions under the proposed territorial system to enable such income to qualify for the DRD, the Discussion Draft proposes a number of anti-avoidance rules (Sections 331A, 331B, 331C and 332).

Subchapter S corporations should not be subject to these anti-avoidance rules given that they are not eligible for the DRD. As such, Subchapter S corporations would not have the same incentive as C corporations to convert income subject to U.S. tax into income exempt from U.S. tax, so applying the anti-avoidance provisions to them would not be necessary or appropriate. The application of these base erosion provisions should be limited to those C corporations eligible for the DRD.

Conclusion

As described above, there appear to be a number of instances where the transition and/or anti-abuse rules related to the proposal are applicable to Subchapter S corporations despite the fact that such corporations are ineligible for the dividends received deduction. Therefore, we respectfully request that the Discussion Draft be modified accordingly to prevent the double taxation resulting from the application of these proposed rules.

The S Corporation Association would be pleased to work with the International Tax Reform Working Group and the broader Ways and Means Committee to ensure that Subchapter S corporations are protected from the application of these rules.

About S-CORP

The S Corporation Association (S-CORP) is the only organization in Washington D.C. exclusively devoted to promoting and protecting the interests of America's 4.5 million S corporations. S-CORP was founded in 1996.