

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

I. Introduction

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

II. Overview of Discussion Draft

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

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

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

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

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

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

III. Analysis of Discussion Draft

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

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

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

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

B. Basic Architecture of the Discussion Draft

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

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

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

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

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

1. Design Issues

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2. Short-term issues

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

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

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

ii. “Old” foreign tax credit issues.

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

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

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

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

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

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

3. Interactive issues

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

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

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

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

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

IV. Conclusion

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