

Questions for the Record for Rep. Richard Neal
W&M SRM Hearing on Camp Territorial Proposal
November 17, 2011
John L. Harrington

Question:

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?

Answer:

To the extent that a shareholder has been taxed on the undistributed income of a foreign corporation, the conceptually right answer is to permit a tax-free distribution of the previously taxed income or to increase basis in the foreign corporation stock to reflect the previously taxed earnings so that the earnings are not taxed twice. New Code section 1247, which would be added by section 302 of the Ways and Means Committee Discussion Draft, provides a [95] percent exemption for gains on the sale of stock in qualified foreign corporations. In the case of “active” foreign corporations, the proposed repeal of section 961 is not particularly significant since [95] percent of the gain would not be taxed. So, although the amount of gain would be overstated in those cases, Congress must weigh the simplification arising from repeal of section 961 with the fact that [5%] of gain would be overstated. From a “rough justice” standpoint, how this and analogous issues are resolved should be reflected in the ultimate rate chosen for the exemption. On the other hand, there are some shareholders in foreign corporations that are not eligible for the [95] percent exemption on sale of their stock but that may be subject to subpart F. These include not just shareholders in foreign corporations that fail to meet the “active” test of section 1247 but also those who are individuals and are not eligible for the [95] percent exemption. For sales of stock in those corporations, failure to allow a basis adjustment such as that in current Code section 961 would overstate gain in those shares. Accordingly, retention of section 961 for sales of stock that are not eligible for the [95] percent is desirable and should be considered by the Committee in the next iteration of the proposal.

Question:

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.

Answer:

Transition rules would mitigate some of the short-term impacts of treating foreign partnerships and branches as CFCs. However, some of these issues, such as the consequences of inadvertent CFC terminations as a result of business ebb and flow that I described in my written testimony, are ongoing and therefore must be addressed in the substantive tax rules. I believe that the transition rules should focus on the goal of assisting taxpayers as they move from the old system to the new system. So, for companies that determine that they should change their business form in light of the new rules, transition rules should facilitate those changes. Thus, transition rules that provide a temporary break from the outbound transfer and branch recapture rules are appropriate in order to effectuate the policies Congress intends in the new system. To the extent that problems will arise on an ongoing basis, however, transition rules are not sufficient. If there are problems in the new system, those have to be addressed in the permanent rules, not in the transition rules.