

TESTIMONY OF T. TIMOTHY TUERFF
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ON
DISCUSSION DRAFT PROVISIONS TO ESTABLISH
A PARTICIPATION EXEMPTION SYSTEM
FOR THE TAXATION OF FOREIGN INCOME

BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES OF THE
HOUSE COMMITTEE ON WAYS & MEANS

November 17, 2011

Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to share my views on the discussion draft for establishing a territorial system taxing foreign income. I am a Tax Partner with Deloitte Tax LLP with over 27 years of experience as a tax attorney and CPA. I am the head of Deloitte's Washington National Tax International Tax Services group, which serves multinational clients engaged in international business. My practice has largely focused on serving U.S. based multinational enterprises conducting business operations outside the United States. I appear today on my own behalf, and not on behalf of Deloitte Tax or a client of Deloitte. I am honored to have been invited to participate in this hearing.

Chairman Camp's discussion draft takes an important step in proposing changes to the U.S. tax rules dealing with international business operations. Congress last substantially revised these rules in 1986. During the 25 years since then, additional restrictions have been placed on the foreign tax credit mechanism resulting in a very complex and burdensome regime. This regime

places an unacceptable strain on both taxpayers in computing and reporting their tax liability and on the IRS and Treasury in administering these provisions.

Important Role Territoriality Plays in the Global Tax System Today

The United States employs a worldwide system for taxation of business income. U.S. corporations generally are taxed on their worldwide income, regardless of where the income is earned, and are allowed a credit for foreign income taxes, limited to 35% of their net foreign-source income. Income earned by foreign subsidiaries from active business operations conducted outside the United States is generally not subject to U.S. tax when it is earned. However, U.S. tax is imposed at the time when the earnings are repatriated to the U.S. parent corporation. Foreign income taxes associated with the repatriated earnings become creditable against the parent's U.S. tax liability. Under the rules of subpart F, U.S. parent corporations pay U.S. tax on certain types of income (generally, passive income or income thought to be easily movable), earned by their controlled foreign corporations (CFCs) regardless of whether or not it is repatriated.

Historically, most of the major capital-exporting nations also employed a worldwide system. But with the dramatic global economic changes of the last 50 years, countries have changed their international tax systems, citing competitiveness concerns. Today, almost all other countries that belong to the OECD have some form of a territorial system. These systems generally exempt foreign income from domestic corporate tax, subject to varying restrictions. Most recently, Japan and the United Kingdom adopted territorial systems of taxation. These movements to

territoriality by our competitors and the relatively high U.S. corporate income tax rate have given rise to serious concerns about competitiveness of U.S. firms. These concerns led to the territorial proposal put forth by Chairman Camp on October 26th of this year. I would like to focus on the impact of the following aspects of the discussion draft:

- Participation Exemption for Foreign Income;
- Deductible Expenses;
- Expansion of Subpart F;
- Transfer Pricing;
- Branches;
- 25% Corporate Tax Rate; and
- Transition Rules.

I. Participation Exemption for Active Foreign Source Income

The discussion draft proposal provides a 95% dividends-received deduction for foreign-source dividends from CFCs, subject to a 365 day holding period. This 95% exemption is similar to the territorial system used by France, Germany and Japan. The United Kingdom recently adopted a territorial system with respect to dividends. This system generally provides for a 100% dividend exemption for dividends received after July 1, 2009 from foreign subsidiaries.¹ The United

¹ The United Kingdom could deny the 100% exemption under an anti-abuse rule where dividends are treated as deductible expenses for local law purposes.

Kingdom's stated motivation for the adoption of this system was to make the United Kingdom a more desirable location in which to organize and operate a corporate residence.²

A participation exemption system is a more competitive alternative to the current U.S. regime that imposes a residual level of U.S. tax on the remittance of foreign earnings back to the United States. The current corporate tax rate of 35% coupled with lower tax rates imposed outside the United States result in an increased tax charge on repatriation of earnings from foreign subsidiaries. This additional charge causes what is often referred to as a "lockout" of earnings, preventing them from being returned to the United States. The proposed 95% dividend exemption system would reduce the U.S. tax charge on remitted earnings to 1.25%, thereby allowing for the movement of capital back to the United States for reinvestment in domestic operations.

The location of business operations in an offshore market is necessary to meet the needs of a global customer base. U.S.-based companies must conduct business outside the United States in order to expand their businesses and stay competitive. Even mid-sized companies find that the growth of business opportunities often requires expansion into non-U.S. markets. In a global economy, companies must address the needs of their current and future customers, regardless of

² See The Independent, March 25, 2008, "Taxation: Foreign Dividends Exempted" by Nick Clark (quoting Alistair Darling, the UK Chancellor at the time the dividend exemption was announced, as stating: "I will maintain a focus on the long-term competitiveness of the UK and to increase our attractiveness as a base for global businesses. To do so, I will introduce an exemption for foreign dividends in 2009 for large and medium businesses, and improve our rules for taxing Controlled Foreign Companies"). The primary motivation for Japan in introducing the 95% dividend exemption, as stated by its Ministry of Finance, was to encourage repatriation of foreign profits. See Japanese Ministry of Finance, "*Heisei 21 Nendo Kaisei Zeihou No Subete*" (An Overview of the 2009 Tax Reform), p. 425, "— *Gaikoku Kogaisha Haitou Riekikin Fusannyuu Seido No Dounyuu* – 1. *Seido Dounyuu No Keii/Shushi*" (I. Introduction of the system for excluding dividends from a foreign subsidiary – 1. Background and purpose of the introduction of the system).

location. An exemption system facilitates the ability of U.S. companies to address the needs of foreign markets while retaining support operations in the United States. Under this system funds may be earned outside the United States and remitted to the United States to pay for research and development and corporate headquarters expenses.

Finally, the enactment of a territorial system will simplify U.S. tax law by significantly reducing the importance of the foreign tax credit. Limiting the use of the foreign tax credit system as the primary means of preventing international double taxation will reduce the burden of expense allocation and the other complex provisions designed to ensure that foreign tax credits do not shelter U.S. source income from U.S. tax. The issues surrounding deductibility of expenses for purposes of determining the taxable income qualifying for foreign tax credit relief has been the source of numerous legislative changes and voluminous regulations. The effect of these rules requires taxpayers to address a complex web of rules designed to restrict foreign tax credits to what is defined as an appropriate amount of foreign source taxable income. Under the discussion draft, the foreign tax credit would primarily be relevant to subpart F income and withholding taxes on interest and royalties earned from foreign loans and licenses. Only one “foreign tax credit limitation” need be computed (rather than separate limitations for separate “baskets”), and only directly allocable expenses would reduce the limitation. Consideration should be given to imposing restrictions on the use of pre-effective date foreign tax credits from active business operations to reduce U.S. tax on passive income.

II. Deductible Expenses

The territorial system of taxation raises the question of whether restrictions should be placed on deductions of a domestic corporation attributable to its exempt foreign income. Rather than prescribe rules disallowing deductions allocable to income excluded from the U.S. tax base by the participation exemption, the discussion draft follows the position adopted in a number of countries which reduce the amount of the exemption, typically to 95%, as a reasonable proxy for expenses incurred in the domestic country that are attributable to exempt foreign income. It is important to note that the deductibility of expenses is a factor in retaining and expanding the employment related to those support functions in the United States. It also has a varying impact among taxpayers, since some businesses are more highly leveraged than others. The United Kingdom, interestingly, chose to allow a 100% exemption for active foreign income and does not place any restriction on deductions. Placing no restriction on deductions is consistent with the policy objective of encouraging the performance of corporate activities in the United Kingdom.³

The discussion draft would also expand our present-law limitation on the current deductibility of interest expense in a manner similar to rules applied to foreign companies investing in the United States through U.S subsidiaries. Current deductions for net interest expense would be subject to the greater of two limits: (1) net interest expense attributed to non-“excess” domestic indebtedness (computed by comparing the U.S. debt to asset ratio to the world-wide debt to asset

³ See e.g. Speech by the Chancellor of the Exchequer, Rt Hon George Osborne MP, at the CBI Annual Dinner, Grosvenor House Hotel, London (May 19, 2010) (stating: “Our aim is to create the most competitive corporate tax regime in the G20, while protecting manufacturing industries. . . . As well as lower rates and a simpler system, I want to reform the complex Controlled Foreign Companies rules that have driven businesses overseas. I want multinationals coming to the UK, not leaving. I am under no illusions. Achieving all this will be hard and it won’t happen overnight. But let us work together for the long term, because ultimately all of Britain’s businesses will be winners if we succeed”).

ratio); or (2) a specified percentage of adjusted taxable income as defined under section 163(j).⁴

The United Kingdom does not restrict the deduction of third party indebtedness incurred in a UK parent entity, irrespective of the level of non-UK operations conducted through foreign affiliates or foreign branches. Under Chairman Camp's discussion draft, a portion of third party net interest expense incurred by a U.S. parent company will not be currently deductible, to the extent the interest expense exceeds the prescribed thresholds. If deductions are not allowed in the United States, companies will consider increasing indebtedness outside the United States, which may increase their overall cost of borrowing.

III. Expansion of Subpart F Income

Under the heading of "prevention of base erosion," the discussion draft includes three alternatives for significantly expanding the existing subpart F rules. Since their first enactment in 1962,⁵ these rules have attempted to protect the U.S. tax base by identifying those types of income that were not related to active business operations and which could be easily relocated to lower taxed foreign affiliates.⁶

⁴ Unless otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

⁵ See Committee on Finance, 87th Cong., 2d Sess., Draft of Statutory Language with Accompanying Explanation of Amendments Proposed by the Secretary of the Treasury on May 10, 1962, to Sections 13, 15, 16 and 20 of H.R. 10650, III (Comm. Print 1962), reprinted in Revenue Act of 1962, Hearings before the Committee on Finance on H.R. 10650, 87th Cong., 2d Sess., (Part Eleven) 4415 (1962). See also S. Rep. No. 1881, 87th Cong., 2d Sess. (1962).

⁶ In the same spirit, section 954(h) was later enacted to provide for deferral of qualified banking or financing income of a CFC engaged in the active conduct of a banking business (the "active financing exception"). The discussion draft does not address the continued application of section 954(h). Continued application of the active financing exception should be considered as part of any participation exemption for income derived by a CFC in the active conduct of a trade or business.

Under Option A of the discussion draft's subpart F alternatives, income derived by a CFC from outside of its country of incorporation would be currently subject to tax in the United States if: (1) the income is from the use of U.S.-transferred or co-developed intangible property; (2) the income exceeds 150% of certain costs allocated to the income other than interest expense and taxes and indirect expenses; and (3) the income is taxed in a local jurisdiction at a foreign effective tax rate of 10% or less.⁷ Option B is an even broader expansion of subpart F requiring all income of a CFC to be currently taxed in the United States if the income is derived outside the CFC's country of incorporation and if it is subject to an effective rate of tax of less than 10%. Option C would tax currently CFC income to the extent attributable to intangible property and subject to a foreign effective tax rate of 13.5%.⁸ However, in a separate provision, a 40% deduction is allowed with respect to both foreign intangible income of the U.S. corporation itself, and any subpart F inclusions of CFC intangible property income that is foreign intangible income—and such income is limited to the sale of property or provision of services in foreign markets.

The proposed Options A and C would impact the ability of U.S. companies to use intellectual property in the course of active business operations conducted outside the United States and thereby weaken their competitiveness as against other similarly situated non-U.S. owned businesses operating in the same markets. In France, Germany, Japan and the United Kingdom, income attributable to sales and services performed by CFCs is not subject to bifurcation

⁷All of the excess intangible income would be subpart F income if the effective tax rate on the intangible income was less than 10% and none of the income would be treated as subpart F income if the effective tax rate exceeded 15%, with a sliding scale applicable to income subject to rates between 10 and 15%.

⁸This rate is determined assuming a 25% maximum tax rate, a deemed deduction of 40% and a high taxed safe harbor under section 954(b)(4) of 90% of the maximum tax rate imposed under the Code. These provisions create a high taxed exception to subpart F income where the income is subject to a 13.5% foreign effective income tax rate.

between intangible-related returns and non-intangible returns under present law. For example, where a parent company resident in any of these jurisdictions establishes a subsidiary in Ireland that utilizes intangible property to manufacture and sell products, the active income of the CFC is generally not subject to current taxation in the parent company's country of residence.⁹

If any of these options were enacted, it would represent the first time that the subpart F rules would look so fundamentally to foreign tax rates for purposes of defining when CFC earnings should be currently taxed in the United States. Historically, subpart F rules have focused generally on whether income was derived from third parties or in the active conduct of manufacturing, performance of services or active licensing of intangible property or active leasing of tangible property. Option A, in addition, has the novel feature of focusing on a CFC's rate of return on expenses. By triggering current taxation when the return exceeds 150%, the option provides an incentive to push deductible development and marketing costs into the CFC, which is inconsistent with the policy objective of the subpart F provisions. By taxing income attributable to intangibles, Options A and C also characterize as base erosion the use of one of the most important inputs to products and services in a number of industries. In effect, U.S. technology is exported in products and services delivered by U.S.-based multinational enterprises throughout the world. Companies use intellectual property to generate profits offshore because that is where they must operate to meet the needs of their global customers.

⁹ A number of jurisdictions require that a CFC meet the requirements of an active trade or business test in order to qualify for exception to current taxation under the relevant CFC rules. For example, in Japan, the CFC must meet the following tests: (i) active business requirements, (ii) substance requirements, (iii) local management and control, and (iv) conduct of a local business.

Under current law, a CFC must pay for the right to use intellectual property outside the United States if the intellectual property is owned by the U.S. parent corporation of the CFC. Treating income from active business operations as subpart F solely on the basis of intangible property that was acquired in an arm's length transaction is inconsistent with the arm's length standard for transfer pricing which is the cornerstone of international taxation for the members of the OECD. The subpart F options, therefore, may actually result in double U.S. taxation of intangible income. First, the intangible assets transferred to a CFC are taxable to a U.S. transferor. Secondly, income earned by the CFC from use of the intangible is subject to another U.S. tax as subpart F income.

The intangible income options also raise concerns related to the effective administration of our tax law. These options would require taxpayers to determine the amount of income of a CFC that is attributable to intangible property. This measurement of intangible income requires taxpayers to "unscramble the economic egg" by identifying the amount of revenue and expenses attributable to intangible property as compared to income of the CFC derived from a return on capital, services, manufacturing or marketing activities. Requiring segregation of the return from intellectual property will result in significant controversy during the examination process as taxpayers and the IRS attempt to subdivide the returns on transactions. Such a theoretical subdivision of income from a single transaction is considerably more complex than adjusting the transfer prices for actual transactions based on other, actual transactions among uncontrolled taxpayers.

Another departure from current law in the discussion draft is the treatment of subpart F income that is remitted back to the United States. Under present law, there is generally no residual U.S. tax imposed on the remittance of CFC earnings that have already been subject to U.S. tax as subpart F income.¹⁰ The discussion draft would first impose a U.S. corporate income tax of 25% on the subpart F income as it is earned by the CFC. Upon remittance, the dividend distribution would be included in the U.S. shareholder's income subject to a 95% dividends received deduction, thereby resulting in an additional level of U.S. tax of 1.25% on the same income. This would mean that 5% of the subpart F income is subject to double U.S. taxation. There does not appear to be a policy reason for imposing a higher rate of U.S. tax on remitted subpart F income earned by a CFC than would have been imposed if such income was generated in the United States. This incremental tax retains, albeit at a lower cost, the lockout of earnings by imposing an incremental charge on repatriation.

The current draft does not provide for the continuation of the CFC "look-through rules" that exclude from subpart F income certain payments of interest, rents and royalties between related CFCs. These payments represent an important source of funding of CFC operations. The rules operate in a manner that allows for active income in one affiliate to be replaced as active income in another affiliate to the extent of the deductible payment. Applied in the context of the draft's participation exemption, there would be no net incremental amount of earnings being exempted because the deductible payment must be allocated to active business income in order to be exempted. These payments should simply be viewed as allowing for the efficient use of capital

¹⁰ Additional U.S. tax may be incurred on the remittance of previously taxed income under subpart F to the extent of the appreciation in the dollar value of a CFC's functional currency at the time of remittance, as compared to the translation rate used to determine the original income inclusion. See section 986(c).

among CFCs, and I recommend that these rules be retained in any future tax regime relating to foreign corporate income.

IV. Transfer Pricing

The current U.S. system places great emphasis on transfer pricing rules under section 482 to ensure that taxpayers do not inappropriately shift income between domestic and foreign operations. Transfer pricing rules are certainly important in a territorial system, because transactions between a foreign subsidiary and its domestic parent will move taxable income into or out of the participation exemption. Some may argue that the territorial system places greater emphasis on transfer pricing because the income is exempt rather than deferred under current law. Given the importance of the reporting of taxable income on tax returns and financial statements related to profits deferred in CFCs, I would suggest that transfer pricing is of equal importance in both systems.

V. Branch Operations

The discussion draft treats foreign branches of domestic corporations like a CFC for all purposes of the Code. This results in a 95% exemption of active business income earned by the foreign branch to its domestic parent. The treatment of foreign branches in territorial tax systems varies according to the system. For example, France, the United Kingdom and Germany will exempt active business income derived from foreign branches. Japan, on the other hand, applies its corporate income tax to all branch earnings, but does not impose its enterprise tax on such

earnings. The importance of branch operations is relevant because many U.S. corporations will conduct foreign operations themselves or through directly-owned flow-through entities.

The discussion draft proposal raises a number of technical issues related to the treatment of branches like subsidiaries for purposes of the Code. For example, will payments between branches be treated like interest and royalties and create subpart F income? Will the conversion from branch status to CFC status be excepted from tax imposed by section 367, dual consolidated loss recapture, branch loss recapture, or overall foreign loss recapture? Will advances between branches be treated as “springing” loans resulting in taxable income? Presumably, branch remittances will be subject to a 1.25% residual tax on remittance, which requires carefully monitoring branch remittances. Finally, the exemption of branch income will presumably require that transfer pricing principles be adopted in order to determine the amount of income attributable to the branch that qualifies for exemption.¹¹

VI. Corporate Tax Rate

While the corporate tax rate is not the primary focus of this hearing, the discussion draft takes the important step of reducing the corporate income tax rate to 25%. A 25% corporate income tax rate would bring U.S. corporate income tax rates in line with the average of OECD countries. Corporate tax rates in other countries have been reduced over the last decade. In 2000, the average corporate income tax rate for OECD countries was 32.6%; by 2010 that average rate had been reduced to 25.4%. During this period, corporate tax rates were reduced in 31 OECD

¹¹ Some companies are required to operate overseas in branch form for regulatory reasons. The proposal will require the application of transfer pricing principles to determine the correct amount of taxable income attributed to branch operations.

countries, including France, Germany, and the United Kingdom.¹² A move to reduce the corporate income tax rate will allow U.S. corporations to be subject to a domestic tax rate that is consistent with that applied in other countries competing for the multinational corporate tax base.

VII. Transition rules

The implementation of any territorial system must address the taxation of prior year's earnings retained in CFCs. The treatment of these earnings will have significant financial statement impact and a mandatory inclusion of 15% of the pre-effective date deferred earnings in taxable income will likely result in additional tax charges reflected in financial statements. Further, a mandatory inclusion of 15% of prior year's earnings will result in a tax cost with no current cash being generated to pay the tax. If earnings have been reinvested in expanding business operations outside the United States, then a company must find other sources of cash in order to pay U.S. tax on previously deferred earnings that are required to be included in income. Japan and the United Kingdom generally do not impose a tax on the remittance of pre-effective date earnings. This decision is consistent with the stated policy objective of promoting the remittance of earnings to grow operations conducted in the home country. The tax imposed on pre-effective date earnings will reduce the funds available for such purposes. This issue will undoubtedly be part of the broader discussion of the fiscal objectives associated with implementing a territorial system in the United States.

Thank you for allowing me to participate in today's hearing.

¹² OECD *Challenges in Designing Competitive Tax Systems*, June 30, 2011