Statement
Of the
U.S. Chamber
Of Commerce

ON: **Hearing on Ways and Means International Tax Reform Discussion Draft**

TO: **Subcommittee on Select Revenue Measures, House Committee on Ways & Means**

DATE: **November 17, 2011**

The Chamber's mission is to advance human progress through an economic,
political and social system based on individual freedom,
incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business -- manufacturing, retailing, services, construction, wholesaling, and finance – is represented. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 115 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. More than 1,000 business people participate in this process.

INTRODUCTION

The Chamber thanks House Subcommittee on Select Revenue Measures (the Subcommittee) Chairman Tiberi for requesting feedback on the international tax reform discussion draft (the Discussion Draft) released on October 26, 2011 by the House Committee on Ways and Means. While the Chamber applauds the transition to a territorial system of taxation, we have initial concerns over certain aspects of the draft that are articulated below. We are continuing our analysis of the Discussion Draft and how it compares to other countries' territorial tax regimes, and we will supplement these initial comments as appropriate.

A BRIEF NOTE ON FUNDAMENTAL TAX REFORM AND PROPOSED RATE STRUCTURE

The Chamber supports fundamental tax reform and, thus, believes tax reform should be comprehensive and should address both the corporate and individual sides of the Code.[1] The Chamber appreciates that the Discussion Draft proposes to lower both corporate and individual tax rates to 25 percent. The Chamber, however, reserves further comments on the proposed rate reductions until additional details are provided with respect to the corresponding base broadening measures that will be proposed.

TRANSITION RULE FOR UNREPATRIATED FOREIGN EARNINGS

The Discussion Draft provides that U.S. shareholders owning 10% or more of the stock of a foreign corporation include in income all pre-effective date, unrepatriated earnings of such foreign corporations. This deemed repatriation applies regardless of whether the unrepatriated earnings are actually distributed to the U.S. shareholders.

Earnings that are not actually distributed by the foreign corporation will be subject to an additional 1.25% tax when subsequently distributed (assuming the distribution qualifies for the new 95% dividends received deduction).

The Chamber seeks to better understand the purpose of this transition rule and determine whether the transition rule is tailored to such purpose. If this transition rule can be narrowed, it should be. As currently drafted, the Chamber has the following concerns:

- Not all unrepatriated earnings are liquid. Thus, we believe that the Committee should consider, for example, exempting from the provision unrepatriated earnings that have been reinvested in plant, property, and equipment.

- The deemed repatriation provision appears to apply to domestic pass-through entities. The Chamber is concerned that pass-through entities are part of the "pay for" to achieve revenue neutrality in the new regime without a corresponding benefit. In this regard, the pass-through entity would not be eligible for the new 95% dividends received deduction.

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[1] All references to the Code are to the Internal Revenue Code of 1986, as amended, and the Treasury regulations promulgated thereunder.

FOREIGN TAX CREDIT CHANGES

The Discussion Draft repeals the credit for deemed paid foreign taxes under Code section 902 that is available to a U.S. corporation that owns 10% of the voting stock of a foreign corporation. The Discussion Draft replaces the credit with a 95% dividends received deduction for the foreign source portion of dividends received from the foreign corporation.

This new participation exemption system applies only to U.S. C corporations. U.S. persons other than U.S. C corporations, including S corporations and other pass-through entities, are not eligible for the new participation exemption system. The Chamber urges the Committee to carefully consider the impact that the Discussion Draft would have on the tax treatment of distributions received by domestic pass-through entities from their foreign subsidiaries.

RETENTION OF SUBPART F

The Discussion Draft retains the Subpart F regime, not only for passive income but also for certain active earnings that are treated as Subpart F income. The Discussion Draft, however, eliminates the Code Section 959 exemption for distributions of previously taxed income.

Under the proposed participation exemption regime, all active foreign earnings, including active earnings that have been previously taxed at the regular rates under Subpart F, will be subject to an additional 1.25% tax when distributed. Thus, active earnings that have been previously taxed under Subpart F will be subject to double taxation.

The Chamber believes the Committee should consider amending Subpart F to apply only to passive income.

BRANCHES TREATED AS CFCs

Under current law, unincorporated foreign branches are simply extensions of the U.S. corporation, as opposed to being separate legal entities. A branch's foreign earnings represent foreign source income earned directly by the U.S. corporation and are subject to U.S. tax at the regular corporate rates, with a corresponding foreign tax credit (subject to the applicable foreign tax credit limitation). Conversely, the U.S. corporation can deduct the foreign losses of a branch against its U.S. profits.

The Discussion Draft treats all foreign branches as controlled foreign corporations (CFCs) but does not explain the policy reason behind this change. It would be helpful for the Committee to provide further explanation of the policy reasons for the proposal so that U.S. corporations may conduct a more thorough analysis of the proposal and offer alternative recommendations if appropriate.

Because the Discussion Draft treats foreign branches as CFCs, they will fall within the participation exemption system, and their earnings will therefore be eligible for the 95% dividends received deduction. Thus, distributions made by the branch from its foreign earnings to the U.S. corporation will be taxed at an additional maximum rate of 1.25%. No foreign tax credits would be available to offset the taxable 5% of the distribution.

Most OECD countries that allow less than a 100% participation exemption regime nevertheless allow a 100% exemption for branches. Accordingly, the Chamber believes the Committee should consider applying a 100% participation exemption system for foreign branches of U.S. corporations as well.

PREVENTION OF BASE EROSION – CHANGES TO SUBPART F

The Discussion Draft includes three alternative Subpart F categories that are intended to prevent base erosion under the participation exemption system.

The Chamber questions the need for any of these alternatives, since other countries that have switched to participation exemption systems do not appear to have experienced base erosion.

The proposed new categories of Subpart F income apply to all U.S. shareholders, whether or not they are eligible for the dividends received deduction. Thus, S corporations and other pass-throughs would be subject to these provisions, even though they do not qualify for the 95% dividends received deduction.

We believe each of these alternatives would reduce the competitiveness of U.S. companies. If needed at all, more time should be spent further developing these alternatives and narrowing their impact so as only to affect the activity intended to be discouraged. The Chamber is continuing to review these proposals and will provide additional feedback at a later date. In the interim, however, we offer the following initial comments on the proposals.

NEW SUBPART F CATEGORY – OPTION A

Under Option A, excess income from transfers of covered intangibles to low-taxed CFCs (foreign effective tax rate of 10% or less) is treated as Subpart F income. Excess income is defined as income connected with the transferred intangible in excess of 150% of the costs (excluding interest and taxes) attributable to such income.

The Chamber is concerned that this provision has been drafted in a manner that is overbroad. First, the Chamber believes that the definition of “covered intangible” is overbroad. A covered intangible could arise, for example, from a CFC to CFC cost sharing arrangement to which no related U.S. person has provided any intangible property – i.e., there has been no potential base erosion due to the outbound migration of intellectual property. Second, the Subpart F treatment applies when a covered intangible is used directly or indirectly in the property giving rise to the income. Using the word “indirectly” may be overbroad.

NEW SUBPART F CATEGORY – OPTION B

Option B would treat as Subpart F income a CFC's earnings that are not derived from an active trade or business in its home country nor subject to an effective foreign tax rate of at least 10%.

This alternative is troubling since it may subject corporate structures with significant substance in terms of people and business activity in low taxed countries to a higher level of taxation. The Chamber believes the focus should more properly be upon structures without substance consistent with business operations.

NEW SUBPART F CATEGORY– OPTION C

Option C creates a new category of Subpart F income for income from the sale of goods or services attributable to intangible property without regard to where the intangible is developed or exploited, resulting in global taxation of income resulting from the use of intangibles. This income, as well as intangible property-related income earned directly by U.S. corporations, would be taxed at a rate of 15% (as modified by the Subpart F high-tax exception).

Under this alternative, intangible property income earned by a foreign affiliate would be subject to an additional 1.25% tax when repatriated (assuming it qualifies for the 95% dividends received deduction). Further, it will be difficult for companies to determine what portion of foreign income is deemed attributable to the exploitation of intangible property.

PREVENTION OF BASE EROSION: THIN CAPITALIZATION RULES

The Discussion Draft includes a provision to limit deductions for net interest expense of U.S. corporations to discourage them from borrowing in the United States to finance overseas operations that may be eligible for the 95% dividend exemption. The provision disallows interest incurred by U.S. groups where the U.S. debt level exceeds the global debt level, or if debt exceeds an unidentified financial ratio.

The Chamber believes that it is important to ensure that the financial ratio takes into account business cyclicality. Moreover, there are many non-tax reasons why U.S. companies need more funding in the United States than the debt ratio would predict. For example, most U.S. companies incur a large percentage of their research and development expense in the United States. If a company is expanding in the United States, it may be appropriate to have a higher level of debt to fund new projects. The Chamber believes the proposed thin capitalization rules should take these considerations into account.

OTHER ISSUES

As with corporations, the United States has long taxed the foreign-earned income of its citizens residing abroad, resulting in double taxation and disincentivizing the hiring of U.S. citizens. Studies have shown that U.S. expatriates employed as managers in foreign affiliates of American worldwide companies are a powerful driver of U.S. exports. No other country taxes its citizens working abroad, and the any transition to a territorial tax system should take this into consideration and end this damaging practice.

CONCLUSION

The Chamber thanks the Subcommittee for the opportunity to comment on the international tax reform Discussion Draft. The Chamber believes that as the Subcommittee and Committee consider fundamental tax reform, it is imperative to shift to a territorial tax system but that system must not be overly onerous to companies seeking to grow, compete, and innovate. We look forward to continuing discussions on this Discussion Draft and working with the Committee and Congress on this vital issue.