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April 15, 2015

The Honorable Rob Portman
Co-Chair, Senate International Tax
Working Group
448 Russell Senate Office Building
Washington, DC 20510

The Honorable Charles Schumer
Co-Chair, Senate International Tax
Working Group
322 Hart Senate Office Building
Washington, DC 20510

Dear Senators Portman and Schumer:

We appreciate the opportunity to provide input on how best to reform the nation's tax code to make it simpler, fairer, and more efficient, particularly in the area of international tax reform. The focus of this letter is the reform of taxation of individually owned controlled foreign corporations ("CFCs").

Current law

In general, U.S. corporations and U.S. individuals pay current tax on their worldwide income. However, if the individuals or corporations conduct their overseas operations through a foreign subsidiary corporation, the foreign corporation's business income generally is not subject to U.S. tax until the income is brought back to the U.S. (typically as a dividend). This ability to defer tax applies even if the income is earned by a CFC.

A 10 percent U.S. corporate shareholder of a CFC is taxed on the dividend from the CFC at its applicable corporate tax rate and generally is eligible for an indirect foreign tax credit. In the case of a dividend to an individual (directly or through a partnership), the dividend is taxed at either ordinary rates, or if the dividend is a qualified dividend, at capital gains rates. No indirect foreign tax credit is available to an individual shareholder for the foreign income taxes paid by the CFC.

Recent Reform Proposals

Reform proposals have either retained the taxation of worldwide income but at lower rates and without deferral or moved to a territorial system. The movement to a territorial tax system is central to the debate of comprehensive international tax reform. Twenty-eight of the 34 current OECD member countries have adopted a territorial tax system. Twenty of the 28 OECD countries with territorial tax systems exempt 100 percent of the eligible foreign subsidiary dividends and the other eight exempt at least 95 percent of eligible dividends.[1] Commentators have raised concerns that some reform proposals have moved away from territorial systems prevalent in many

[1]Source: PWC, Evolution of Territorial Tax Systems in the OECD April 12, 2013.

developed countries and would harm domestic investment, job creation and competitiveness.[2] International tax reform should establish an appropriately balanced territorial system that does not encourage companies to locate abroad.

Recent international tax reform proposals implementing a territorial tax regime take the form of a dividend exemption system that exempts from U.S. tax dividends (or a percentage of dividends) paid by a CFC to its U.S. parent corporation; thus, exempting such income from U.S. tax to the extent of the dividend exemption. The dividend exemption is achieved through a dividends received deduction, but these international tax reform proposals provide an exemption only to corporate shareholders. No proposals to date have addressed non-corporate shareholders of CFCs (i.e., individuals), although the same concern for incentives and disincentives apply.

Individual and Pass-Through Owners of Foreign Corporations

The vast majority of businesses in the United States are organized for tax purposes as sole proprietorships. The number of pass-through entities surpassed the number of C corporations in 1987 and nearly tripled from 1987 to 2009, led by growth in small S corporations (those with less than $100,000 in assets) and limited liability companies taxed as partnerships.[3] In 2011, partnerships filed more than 3 million tax returns. Of the 5.8 million corporate tax returns filed for 2011, 4.2 million were for pass-through entities (including S corporations).[4] According to OECD revenue statistics, corporate income tax on profits (exclusive of capital gains) accounted for just 9.2 percent of total U.S. federal tax revenues in 2012.

Recommendations

In a pure territorial system, foreign sourced income of a CFC would be untaxed even if repatriated. Recent proposals based on a worldwide system eliminate deferral but provide for a lower tax rate for corporate shareholders than is imposed under current law. For example, recent proposals have provided a 75 percent dividends received deduction to 10 percent U.S. corporate shareholders of CFCs (i.e., an 8.75 percent tax rate using current rates). Thus, any tax reform should provide consistent and proportionately lower rates to all 10 percent shareholders of a CFC. For example, if dividends paid to a 10 percent corporate shareholder are eligible for a 75 percent dividends received deduction, then dividends received by 10 percent non-corporate shareholders of the CFC should also be eligible for a 75 percent deduction, providing for an effective tax rate of 9.9 percent if the dividend is not a qualified dividend and 5 percent if the dividend is a qualified dividend using current rates. Failure to do so will result in a disparate and unfair burden on individual owners of CFCs and preserve the lockout effect, frustrating the fundamental policy objectives of international tax reform.

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[2] "Selected Issues Relating to Choice of Business Entity" JCX-20-12 March 5, 2012.
[3] See, TIE Coalition letter to Chairman Baucus and Ranking Member Hatch, February 3, 2014.
[4] Internal Revenue Service, Statistics of Income Corporate Returns OneSheet 2011, Partnership Returns OneSheet 2011.

In today's global economy, non-U.S. subsidiary corporations are utilized by large and small corporate and non-corporate U.S. taxpayers to conduct business activities abroad. If an exemption system is adopted as part of international tax reform, it should apply to all shareholders of non-U.S. corporations and not be limited to 10 percent corporate shareholders of non-U.S. corporations. International tax reform should provide a comparable exemption from income for earnings distributed by a CFC to all 10 percent U.S. shareholders, whether they be individuals or corporations.

We appreciate the opportunity to provide comments to the working group on international tax reform, and particularly the impact of recent proposals on individual taxpayers. Please contact Michael Levy at 202.872.5281 or me at 303.223.1158 if we can provide further information on these issues.

Sincerely,

Greg Berger

Gregory W. Berger