COMMITTEE ON
WAYS AND MEANS
CHAIRMAN DAVE CAMP

Summary of Ways and Means Discussion Draft: Participation Exemption (Territorial) System

Background. As part of its pursuit of comprehensive tax reform, the House Ways and Means Committee ("the Committee") has released a discussion draft of one discrete component of broader tax reform legislation: a participation exemption for certain foreign-source income (sometimes referred to as a "territorial" system). The Committee is releasing this draft because it views the participation exemption as a fundamental change in the way the United States taxes cross-border activity, and in the interests of transparency seeks feedback from a broad range of stakeholders, taxpayers, practitioners, economists, and members of the general public on how to improve this proposed set of rules. The Committee anticipates releasing future discussion drafts on other components of tax reform legislation, but has started with the participation exemption because it reforms one of the most complex and challenging areas of Federal tax law.

Summary of Discussion Draft. The discussion draft is intended to be revenue neutral in and of itself when considered as part of comprehensive tax reform legislation. The Committee does not believe that domestic base broadening should be used to finance international tax relief, and vice versa. Specifically, the discussion draft would:

- Reduce the corporate tax rate by ten percentage points, to 25%. This rate reduction would be accomplished without increasing the deficit by broadening the tax base. The broader legislation also would reform the individual income tax by broadening the base and lowering the rates for individuals, families and small businesses while also simplifying tax compliance. Those reforms – including the necessary base-broadening provisions – which are crucial to the Committee's tax reform agenda, are not included in the discussion draft, but placeholders exist to make clear that the Committee continues to place a high priority on a comprehensive approach to tax reform.

- Provide a deduction equal to 95% of foreign-source dividends received by a 10% U.S. corporate shareholder from a controlled foreign corporation (CFC). In addition, 95% of capital gains from the sale of shares in a CFC by a 10% corporate shareholder would be excluded from income, as long as a one-year holding period requirement is met and at least 70% of the assets in the CFC are used in the active conduct of a trade or business. (Capital losses on shares of active CFCs would be disallowed.)

- Treat foreign branches of U.S. parent companies as CFCs.

- Treat foreign corporations that are not CFCs but have 10% U.S. corporate shareholders (so-called "10/50 companies") as CFCs if such shareholders elect to treat all of their 10/50 companies as CFCs to avail themselves of the 95% exemption. Similar rules would apply to partnerships.

- Use the subpart F rules to treat certain types of passive and highly mobile income as currently included in taxable income by the U.S. parent, whether or not repatriated, and allow foreign tax credits for this type of income. Royalties paid by a CFC to the U.S. parent would continue to be subject to U.S. tax, but under one of the options for anti-base erosion rules described below, such royalties would be subject to a maximum rate of tax of 15%.

- Adopt a transition rule that would apply a 5.25% tax to all existing foreign earnings currently held offshore, whether or not such earnings are repatriated. Taxpayers could use a ratable portion of their foreign tax credit carryovers to further reduce the 5.25% tax. In addition, they could elect to pay this tax in up to eight annual installments. Once paid, such earnings would benefit from the 95% exemption if brought back to the United States as a dividend.

- Address concerns expressed by commentators that under a participation exemption system, U.S. companies would have an incentive to locate debt in the United States to generate deductible interest expense that could be used to finance exempt foreign income, thus eroding the U.S. tax base. The Committee believes that reducing the corporate rate to 25% substantially mitigates this concern. In addition, the Committee has developed a "thin capitalization rule" that would disallow a portion of net interest expense (i.e., the excess of interest expense over interest income) if a U.S. company that is a member of a worldwide group fails two tests: (1) the U.S. group is overleveraged relative to the worldwide group; and (2) the U.S. company's net interest expense exceeds a certain percentage of adjusted taxable income.

- Address concerns expressed by commentators that under a participation exemption system, U.S. companies would have an increased incentive to shift income to foreign jurisdictions, especially through the migration of intangible property overseas. To this end, the Committee has included three possible anti-abuse rules for consideration: (1) President Obama's "excess returns" proposal; (2) a variation on the low effective tax rate test used in other countries such as Japan; and (3) an option that would lower the corporate tax rate for all foreign intangible income (whether earned by a U.S. parent or its CFCs) to only 15%, but would treat a CFC's foreign intangible income as subpart F income if it is taxed at a rate less than 13.5% (90% of the U.S. rate). This last option combines 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.

- Finally, the discussion draft would simplify the international tax rules by repealing a number of provisions that would become superfluous under the participation exemption regime, including rules relating to deemed-paid foreign tax credits, multiple foreign tax credit baskets, suspension of foreign tax credits until related income is taken into account, investments in U.S. property, and previously taxed income.

Unaddressed Issues. The Committee recognizes that the discussion draft omits numerous technical and policy issues that might need to be resolved in a final product and invites comment on how to address certain provisions, such as those related to:

- Overall domestic and foreign loss accounts
- Tax redeterminations – refunds and or additional taxes paid
- Subpart F changes, including with respect to recapture accounts
- Dual consolidated losses
- Tax Treaty implications
- Cross-border reorganizations

Questions. While the Committee invites input on all aspects of the discussion draft, there are a few areas that the Committee wishes to highlight as topics on which the Committee is especially interested in receiving constructive feedback.

- Which of the three base erosion options would best protect the U.S. tax base with minimum impact on the competitiveness of American businesses? What modifications could be made to make one or more of the options more workable? If these three options are undesirable, what other effective options exist to deal with base erosion, especially with respect to intangibles?

- How can thin capitalization rules be designed to effectively protect the U.S. tax base with minimum impact on the competitiveness of American businesses?

- What are the pros and cons of treating foreign branches as CFCs? Should foreign branches continue to be treated as disregarded entities instead?

- How should foreign partnerships with U.S. corporate partners owning interests of at least 10% be treated? What special rules might be necessary to incorporate them into the new regime?

- Is the 95% exemption for certain capital gains appropriate? Are any additional anti-abuse rules needed in this area?