COMMITTEE ON
WAYS AND MEANS
CHAIRMAN DAVE CAMP

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

- Makes clear that tax reform will reform the individual income tax by providing simplification, fairness, and stronger incentives to work, invest, and create jobs for families and small businesses. (Specific policies are not explicitly identified in the discussion draft.)

- Reduces U.S. corporate tax rate to 25%, making the United States a more attractive place to invest and create jobs. (Specific base broadening policies that will accompany the 25% rate are not explicitly identified in the draft.)

- Exempts 95% of certain foreign-source income from U.S. tax. The exemption applies to dividends paid by foreign companies to U.S. corporate shareholders owning at least 10% of the shares. It also applies to capital gains from sales of shares in foreign companies by 10% U.S. corporate shareholders. The 10% ownership test distinguishes active participants in a business from portfolio investors.
  - Thus, the effective U.S. tax rate on most foreign dividends would be 1.25% (25% rate multiplied by the 5% of income that is not exempt) – putting American companies on a more level playing field with foreign competitors and ending the "lock-out effect" that discourages these companies from bringing foreign earnings back to the United States.
  - Dividends and capital gains from foreign companies that are less than 10% owned by domestic corporations would be treated the same as under current law.

- Includes a number of anti-abuse rules to prevent erosion of the U.S. tax base and help make the participation exemption system a revenue neutral component of tax reform, such as:
  - Anti-deferral rules ("subpart F") that immediately and fully tax domestic companies on the passive income of foreign companies.
  - Thin capitalization rules that prevent U.S. companies from borrowing heavily in the United States (generating tax deductions to reduce taxes on their U.S. income) to finance income from overseas operations (which is eligible for the 95% exemption).
  - Income shifting rules that prevent U.S. companies from avoiding U.S. tax by transferring highly valuable intangible property to foreign companies that pay little or no tax.

- Foreign tax credits still would be available to mitigate double taxation of non-exempt foreign income – such as passive income and royalties.

- All pre-effective date, tax-deferred foreign earnings of foreign companies owned by 10% U.S. shareholders would be taxed once at a low tax rate (similar to a repatriation holiday). U.S. companies could pay this tax ratably over eight years, and these earnings could then be brought back to the United States under the exemption system.