



January 16, 2014

The S-CORP Comments to Senator Baucus's International Tax Reform Staff Discussion Draft

The S Corporation Association (S-CORP) appreciates the opportunity to comment on the November 19, 2013 international tax reform staff discussion draft released by Senate Finance Committee Chairman Max Baucus (the "Discussion Draft").

The S Corporation Association's comments provided below are focused on ensuring that Subchapter S corporations and their individual shareholders are treated equitably under the Discussion Draft, without addressing larger scope issues such as whether the draft promotes its stated objectives including importantly the promotion of U.S. growth and job creation.

Option Y

Option Y provides a participation exemption system with respect to the taxation of active foreign earnings in the form of a 100 percent dividends received deduction ("DRD"). It is our understanding that the DRD is limited to Subchapter C corporations and that, therefore, Subchapter S corporations with controlled foreign corporations ("CFCs") are not entitled to this deduction.

Subchapter S corporations with CFCs are, however, subject to the expansion of Subpart F contained in Option Y, including the inclusion of United States related income in Subpart F income and the treatment of so-called "low taxed income" as Subpart F income. In light of the fact that Subchapter S corporations are not entitled to the DRD, S-CORP believes it is inappropriate to subject such corporations to the expanded Subpart F regime as such expansion effectively serves as an anti-abuse rule to prevent so-called "profit shifting" under the new DRD regime.

The net effect of the application of the Subpart F expansion is to subject individual shareholders of Subchapter S corporations to accelerated U.S. taxation of foreign earnings without the benefit of the DRD with respect to other foreign earnings to mitigate the impact of such acceleration.

Such effect is exacerbated by the fact that individual shareholders of Subchapter S corporations are only eligible for the Section 901 direct foreign tax credit, and are not eligible for the Section 902 indirect foreign tax credit (or its proposed successor provision in the Discussion Draft),¹

¹ It is contemplated under both Option Y and Option Z that the Section 902 indirect foreign tax credit would be repealed and replaced with a deemed-paid credit to a domestic corporation with respect to any income inclusion under Subpart F, similar in effect to current law Section 960. It is our understanding that similar to the Section 902 indirect foreign tax credit, an individual shareholder of a Subchapter S corporation would not be eligible for this new deemed-paid credit.

resulting in double taxation. This results in "cross subsidizing" as the Discussion Draft effectively raises taxes on the international operations of Subchapter S corporations, including small and mid-size Subchapter S corporations, in order to finance the DRD benefit for Subchapter C corporations.

Option Z

The expanded Subpart F regime as proposed in Option Z repeals deferral and accelerates the U.S. taxation of all foreign earnings for all taxpayers, including individual shareholders of Subchapter S corporations.

Essentially, Option Z replaces the current system with a flow-through system in which all U.S. taxpayers are treated as earning directly the foreign income earned through CFCs. As noted above, however, individual shareholders of Subchapter S corporations are only eligible for the Section 901 direct foreign tax credit, and are not eligible for the Section 902 indirect foreign tax credit (or its proposed successor provision in the Discussion Draft). This inequity is mitigated to some extent under the current rules by deferral.

S-CORP believes it is inappropriate to uniformly repeal deferral and accelerate the U.S. taxation of foreign earnings for all taxpayers where such taxpayers are subject to different rules for foreign tax credit purposes. Therefore, S-CORP respectfully requests that consideration be given to the unique foreign tax credit rules applicable to individual shareholders of Subchapter S corporations to ensure that such shareholders are not treated inequitably under Option Z.

Provisions Common to Option Y and Option Z

It is contemplated that both Option Y and Option Z will contain a deemed repatriation provision based on a modification to Section 965 with respect to accumulated deferred foreign earnings. With respect to Option Y, since the deemed repatriation provision is effectively a transition rule to, or "toll charge" for, the DRD, S-CORP agrees with the Discussion Draft's approach not to apply the deemed repatriation provision to individual shareholders of Subchapter S corporations (given that they do not benefit from the DRD) in that context.²

It is also contemplated that both Option Y and Option Z will contain a modification to the entity classification rules (the so-called "check-the-box" rules). While S-CORP is reserving comment on the advisability of such modification as a general matter, it does agree with the Discussion

² Chairman's Staff Request for Comments on Certain Technical and Policy Issues Raised in the Staff Discussion Draft (Nov. 19, 2013) ("it should be noted that amended section 965 only applies to corporate U.S. shareholders").



Draft's approach that such modification does not change the treatment of foreign branches.³ Respecting the treatment of foreign branches is particularly important to Subchapter S corporations who chose to operate in branch form to avoid double taxation, in light of the unavailability of the Section 902 indirect foreign tax credit (or its proposed successor provision in the Discussion Draft) to individual shareholders of Subchapter S corporations, who are only eligible for the Section 901 direct foreign tax credit. Indeed, the magnitude of the issues described above would be significantly greater if the current treatment of foreign branches was in fact modified.

Conclusion

The S Corporation Association appreciates the opportunity to comment on the Discussion Draft and would be pleased to work with the staff to ensure that Subchapter S corporations are treated equitably. S-CORP recognizes that there are multiple mechanisms to ensure such equitable treatment of individual shareholders of Subchapter S corporations and looks forward to working with the staff to determine which mechanism would be most efficient and effective, as well as consistent with the stated objectives of the draft.

We respectfully request that the guiding principles for development of such a mechanism be that (i) individual shareholders of Subchapter S corporations only be subject to any applicable transition or anti-avoidance provisions contained in the Discussion Draft (or any future version of such draft) if such shareholders also benefit from any applicable tax relief provisions (such as the DRD), and (ii) the unique foreign tax credit rules applicable to individual shareholders of Subchapter S corporations (i.e., that such shareholders are eligible for the Section 901 direct foreign tax credit but not eligible for the Section 902 indirect foreign tax credit) be given particular consideration.

About S-CORP

S-CORP is the only organization in Washington, D.C. exclusively devoted to promoting and protecting the interests of America's 4.5 million S corporations. S-CORP was founded in 1996.

³ Summary of Staff Discussion Draft: International Business Tax Reform (Nov. 19, 2013) ("The staff discussion draft does not change the current treatment of foreign branches (that is, overseas business conducted directly by U.S. corporations as opposed to those undertaken through a foreign subsidiary).").