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Chairman Hern and Members of the Global Competitiveness Tax Team:

On behalf of its members, the S Corporation Association appreciates the opportunity to respond to your request for comments "on the United States' current international tax code and the OECD Pillar 1 & 2 framework."

The S Corporation Association has a long history of advocacy on international tax issues. While this discussion typically focuses on C corporations, many S corporations and other pass-through businesses engage in international commerce as exporters, owners and operators of foreign branches, and the owners of controlled foreign corporations (CFCs).

As such, these businesses face many challenges specific to their pass-through status that should be understood by the Global Competitiveness Tax Team.

Section 199A and International Income

The Tax Cuts and Jobs Act (TCJA) offered C Corporations a system where they effectively pay no US tax on what might be described as "normal" earnings from their foreign operations. For a business earning typical rates of return and paying a reasonable level of foreign tax, the new tax regime imposes little or no additional US tax at the entity level.

This new, "territorial" system is by all accounts an improvement on our old "world-wide" approach. It has made the US more competitive and completely shut-down the previous trend of US corporations off-shoring their headquarters and operations to low-tax countries. There is also strong evidence that the new approach has resulted in increased levels of domestic investment, either because of increased repatriated earnings or new direct foreign investment.

The outcome for S corporations, however, was not as clear cut. Under the TCJA, S corporations with foreign branch operations are forced to pay their US tax immediately and at the maximum individual tax rate on their foreign income while those with CFCs are required to pay an additional, US tax at the time the income is earned. This outcome is a result of the following policies:

- The Section 199A pass-through deduction does not apply to foreign-source operating income;
- The TCJA's territorial provisions exclude S corporations and other pass-through entities;
- The TCJA's GILTI tax imposes a 37-percent worldwide minimum tax on the income of CFCs owned by S corporations; and
- The Section 962 election results the immediate taxation of S corporation owners rather a tax imposed only when the income is distributed to shareholders.

Section 199A

The pass-through deduction (Section 199A) is applicable to domestic income only. The deduction is available to *foreign* pass-through entities that have effectively connected income taxed on a US return, but it does not apply to a *US* entity that has checked the box to include its foreign operating income on its US tax return.

This penalty imposed on the foreign earnings of S corporations is particularly harmful as the Tax Code effectively encouraged S corporations to adopt the branch model in the past. Pre-TCJA rules precluded S corporations from claiming indirect foreign tax credits – that is, credit for taxes paid to foreign jurisdictions on income that had been earned in the past -- on their foreign earnings. To receive credit for foreign taxes paid, an S corporation would have to repatriate its foreign earnings immediately, regardless of how the foreign operations were structured.

As a result, most foreign operations of S corporations were conducted under the branch model. Now, under the TCJA, those earnings are excluded from the Section 199A deduction and taxed immediately at rates up to 37 percent.

GILTI

The GILTI tax applies to foreign income exceeding a tangible-asset-based standard rate of return. In calculating their GILTI tax, C Corporations get to offset the income of their foreign subsidiary with a deduction that effectively turns the GILTI levy into a minimum tax of 12.5 percent. If the foreign subsidiary of a C corporation has an effective foreign tax rate that exceeds 12.5 percent, there is no additional US tax.

As a matter of drafting, the GILTI tax is composed of two parts -- Section 951A contains the income inclusion and Section 250 contains the applicable deduction. While Section 951A includes S corporation income and therefore imposes the GILTI tax on those businesses, Section 250 excludes the same businesses from the deduction, which is accessible only to C Corporations.

The result is S corporations are excluded from the TCJA's territorial treatment and must pay tax on their foreign source income immediately (even if they are organized as a CFC) and at the highest marginal rates. The bottom line is GILTI imposes a 37-percent worldwide minimum tax on S Corporations.

Section 962

The Section 962 election was adopted to address these challenges by allowing the owner of an S corporation an election to treat any foreign income as corporate income for GILTI purposes. This election helps level the treatment by giving S corporations with CFCs access to the deduction under Section 250. As noted in a recent Tax Notes article:

> *The original purpose of section 962 was "to avoid what might otherwise be a hardship in taxing a U.S. individual at high bracket rates with respect to earnings in a foreign corporation which he does not receive." The provision was intended to give individuals "assurance that their tax burdens, with respect to these undistributed foreign earnings, [would] be no heavier than they would have been had they invested in an American corporation doing business abroad."*

For the most part, Section 962 succeeded in that goal. Section 962 does not allow, however, the S corporation to enjoy the dividends received deduction under Section 245A. This is significant as Section 245A allows C corporations to repatriate the earnings of their CFCs with no additional US tax owed until those earnings are distributed to the shareholders of the domestic parent corporation. By precluding S corporations from Section 245A, a similar S corporation under Section 962 is required to pay shareholder level taxes immediately at the entity level.

For companies seeking to retain foreign earnings within the domestic parent corporation – as opposed to distributing them out to shareholders – this treatment gives the C corporation a clear advantage over an S corporation, even when the S corporation shareholders have made the Section 962 election. The C corporation can defer the second layer of tax indefinitely, whereas the S corporation must pay the tax immediately.

As a result, S Corps with CFCs are less likely to repatriate earnings from overseas, undermining the purpose of moving to territorial treatment.

Recommendations:

To fix these issues, we recommend the following:

- Section 199A should be expanded to apply to foreign-source income; and
- S corporations making the Section 962 election should be given access to the Section 245A dividends received deduction, together with rules ensuring the repatriated earnings are subject to US tax when they are distributed to the domestic parent corporation shareholders.

IC-DISC

The Interest Charge Domestic International Sales Corporation (IC-DISC) has been helping small and closely-held exporters compete in foreign markets for decades. The IC-DISC was created in the 1980s to improve the competitiveness of smaller U.S. firms when they export products overseas. Firms may set up an IC-DISC when they operate domestically and export to foreign markets. Dividends from an IC-DISC are subject to the same tax rate as other qualified dividends.

The essential characteristics of the IC-DISC structure makes it an ideal means of promoting U.S. products overseas. The lower rate applies to dividends from export income only, while the structure of the IC-DISC lends itself to small and closely-held businesses. It allows these firms to compete in overseas markets against rivals who often benefit from specific, targeted government subsidies.

Strength in US exports has been a bright spot in the economy and the emergence of the small and mid-size exporter as a source of investment and job creation is a good news story that should be encouraged. Raising tax rates on American exporters, on the other hand, makes little sense. A broad goal for next year's tax battle should be to make the U.S. a more attractive place to invest while reducing the incentive for firms to move jobs and facilities overseas. The IC-DISC was enacted to accomplish exactly these goals.

We recommend that Congress reaffirm its support for small and closely-held exporters by supporting the IC-DISC.

Pillar 2

Finally, the Pillar 2 process has significant implications for pass-through businesses that are important for Congress to understand.

The current plan includes a carve-out for business income in the US that passes through to a taxpayer when the taxpayer pays a sufficiently high effective tax rate. For those pass-through businesses, they effectively would be exempt from the proposed Pillar 2 minimum tax regime.

The carve-out, however, only applies if the *direct* shareholder of the pass-through entity pays tax, either as an individual or a trust (such as an ESBT). In situations where an S corporation has trust ownership where the trust is not taxed directly -- such as a grantor trust where the grantor pays the tax rather than the trust – the taxes paid by the indirect owner would not count towards the minimum tax, so a family businesses with trust ownership would be at increased risk of paying the Pillar 2 top-up taxes.

There is an additional challenge. Most S corporations with foreign operations make a check-the-box election to treat their foreign subsidiaries as branches and thus all the branch income – less applicable foreign tax credit offsets – flows onto the S corporation return and is taxed at the shareholder level. As currently drafted, however, this foreign subsidiary income is *not* eligible for the carve-out referenced above where the direct owner of the S corporation is a taxpayer.

We believe this result is an oversight, as the foreign income is taxed in the same way as domestic-source income at the S corporation shareholder level. In this case, the US income of an S corporation could be exempt from Pillar 2 via the carve-out while the income from its foreign subsidiaries would be subject to Pillar 2 and its possible top-up taxes.

Finally, in an issue that affects both S corporations and C corporations, it is unclear whether any Pillar 2-type minimum tax payments would be credited against the company's US tax liability, as are other foreign taxes paid by US businesses. Ensuring that a business receives credit for the foreign taxes it pays is a critical means of ensuring US businesses are not penalized for operating overseas.

Recommendations:

To fix these issues, we recommend the following:

- The Pillar 2 pass-through carve-out be expanded to include S corporations and other pass-through businesses with both direct and indirect owners that pay taxes at a high marginal rate; and
- Make certain that any Pillar 2-type minimum tax payments are credited against US tax liabilities.

Conclusion

The TCJA set the foundation for a more competitive international tax system. Next year's fiscal cliff is an opportunity to build on that foundation and fix several imbalances in the treatment of S corporations and other pass-through businesses that operate internationally. It is also an opportunity to address pending challenges with the Pillar 2 process and make certain that family businesses are not penalized for how they are organized.

The S Corporation Association appreciates the opportunity to offer these suggestions and welcomes the chance to discuss these issues further.

Sincerely.

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