Honorabe Lloyd Doggett  
U.S. House of Representatives  
201 Cannon House Office Building  
Washington, D.C. 20515

Dear Mr. Doggett:

This is in response to your request of March 23, 2011, for revenue estimates of two proposals to modify section 965 of the Internal Revenue Code ("Code").

**Description of the Proposals and Revenue Estimates**

Section 965 provides an elective, temporary, 85-percent dividends-received deduction ("DRD") for certain dividends received by a domestic corporation from controlled foreign corporations, subject to a number of conditions and limitations. Included in these limitations are requirements that eligible dividends are: (1) in excess of a specified level of historical average repatriation; (2) no more than the greater of $500 million or the amount of overseas earnings identified for financial accounting purposes as permanently reinvested earnings ("PRE," which is discussed in detail below); and (3) reinvested in the United States pursuant to a dividend reinvestment plan approved by the management and board of directors of the electing corporation and meeting certain other criteria. An election under section 965 was available only for either the taxpayer's (i) last taxable year beginning before the date of enactment of section 965 (which was October 22, 2004) or (ii) first taxable year beginning during the one-year period beginning on such date of enactment.

It is assumed that your respective proposals would permit an election under section 965 for the taxpayer's first taxable year beginning after December 31, 2010, with appropriate changes to other dates and provisions necessary to adhere to the intent of section 965. The first proposal retains the 85-percent DRD already in section 965, while the second proposal permits a 70-percent DRD.²

² The 85-percent DRD results in a 5.25 percent U.S. tax rate (0.15 multiplied by the top statutory corporate rate of 35 percent) on the entire repatriation before taking account of foreign tax credits and expense disallowance, while a 70-percent DRD translates into 10.5 percent U.S. (0.30 multiplied by the top statutory corporate rate of 35 percent) tax rate before such items are taken into account.
We estimate that the respective proposals would change Federal fiscal year budget receipts as follows, assuming that each would be enacted on June 30, 2011:

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NOTE: Details do not add to totals due to rounding.

Explanation of the Revenue Estimates

Our revenue estimates of these modifications of section 965 draw from the evidence on usage of section 965 in the 2004-2006 period, as well as evidence from other temporary reductions or holidays in areas such as sales taxation and the taxation of capital gain income.

Each estimate includes three major components. The first and smallest component involves the tax reduction afforded under section 965 for certain dividends that taxpayers are predicted to repatriate in the budget period under present law even in the absence of enactment of the proposal. For taxpayers that are predicted to be repatriating these dividends in years 2011

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2 Details on our estimating approach to the original enactment of section 965 can be found in Edward D. Kleinbard and Patrick A. Driessen, “A Revenue Estimate Case Study: The Repatriation Holiday Revisited,” Tax Notes, September 22, 2008, pp. 1191-1202.

3 Over the last two decades except for the years affected by the enactment of the original section 965, annual dividend repatriations have ranged from $50 to $100 billion, and these repatriations tend to mix with other types of foreign source income, so it is difficult to measure U.S. residual tax on repatriated dividends alone. Because we assume present law for establishing baseline revenues for the purpose of evaluating the revenue effects of each proposal, it is assumed that the provisions in the Code permitting the deferral of earnings from certain financial activities under sections 953 and 954 of the Code, and the “look through” of certain payments between related parties for the purpose of determining eligibility for deferral under section 954(c) (6), are not extended past their expiration dates in 2012.
and 2012 notwithstanding the proposals, the extent to which taxpayers elect section 965 is a U.S. tax “windfall” for them that reduces U.S. tax receipts.

The second major component of each estimate captures the U.S. tax effects associated with taxpayers changing their dividend repatriation amounts and/or timing in response to each proposal. Taxpayers would accelerate the repatriation of dividends to qualify for section 965: some of these dividends would be accelerated from within the budget period,4 say from 2013 or 2015 into 2011, and other accelerated dividends qualifying for section 965 would not otherwise be repatriated in the budget period (nor perhaps for many years after that). There are several ways that these altered dividend payments affect U.S. tax receipts. First, dividends qualifying for section 965 would be 85-percent (or 70-percent) exempt, with foreign tax credits still permitted for the non-exempt portion. For example, a taxpayer may pay $4 of U.S. tax under the 85-percent DRD proposal or alternatively $8 of U.S. tax under the 70-percent DRD proposal (after accounting in each case for foreign tax credit and any expense disallowance required by section 965) on a $100 dividend in 2011 that, absent qualifying for section 965, would not have been repatriated in the 2011-2021 period.5 Second, any dividend that is accelerated to qualify for section 965, but which would have otherwise been repatriated later in the budget period after section 965 expires, would avoid potential residual U.S. tax that would have been paid in the

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4 Dividend payments from CFCs to related U.S. persons could also be delayed if there is a legislative window leading to an announcement effect that permits taxpayers to delay repatriation to maximize exemption under section 965.

5 After the enactment of section 965 in 2004, there was interest in, and some confusion about, the U.S. tax receipts associated with the dividends qualifying for section 965. The 85-percent DRD enacted in 2004 translated into a 5.25 percent nominal U.S. tax rate on qualifying dividends. However, foreign tax credits are permitted against the non-exempt portion of qualifying dividends, and there may be some expense disallowance requiring the denial of certain domestic tax deductions. The data presented by Melissa Redmiles, “The One-Time Received Dividend Deduction,” IRS Statistics of Income Bulletin, 27:4 (Spring 2008), pp.102-14, suggests that the applicable residual U.S. tax rate, or initial “toll charge,” on all qualifying dividends after accounting for these other factors was somewhat below four percent. As suggested above, this toll charge is just one part of the estimate, because the source of the qualifying dividends has to be accounted for along with the change in potential tax receipts associated with the projected present law counterfactual activity as described below, and other taxpayer behavior that is not captured by the acceleration of repatriated dividends to qualify for section 965 must be accounted for.
absence of section 965. For example, a $100 dividend that would have been repatriated under present law in 2013, and would have resulted in a $25 U.S. residual tax at that time, would now instead incur $4 in U.S. tax under the 85-percent DRD proposal as it qualifies for section 965 in 2011. In addition, the uses by U.S. firms of the dividend payments that were induced or accelerated by section 965 would change the U.S. tax base. For example, a company may increase its dividend as a result of section 965, and as a result shareholders may be liable for additional individual taxes.

The final component of the estimates takes account of how each proposal would affect the prospective decisions of taxpayers about where to locate investment and/or income. As discussed below, ease of repatriation is one consideration in such decisions, and enactment of section 965 would be regarded by some taxpayers as altering the existing geographic location incentives. If firms anticipate that future repatriation of foreign earnings to meet such needs could occur with little U.S. residual taxation, firms would be less constrained in their location decisions, and that behavioral effect of section 965 also is accounted for in the revenue estimates of your proposals.

To summarize, the revenue estimates consider the U.S. tax implications of how each proposal: (1) affects repatriations that will occur under present law with no assumed change in amount or timing; (2) causes the acceleration of repatriated dividends from both outside and inside the 2011-2021 budget period in order to qualify for section 965; (3) affects the recognition

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6 As we discuss below, we expect that these repatriations will increase under the present law baseline during the fiscal year 2011-2021 period because of the tension between domestic needs and the growing stock of deferred overseas income.

7 These tax base effects owing to the uses of repatriated funds depend upon whether funds would not have been repatriated in the budget period without section 965, as, for example, these tax base effects can be accelerated in the same ways that repatriated dividends can be accelerated. In addition, shareholders who receive an increased dividend, or have their stock repurchased, have discretion in managing their portfolios to achieve their own cash and investment needs. For example, an investor whose shares are bought back by Company A due to section 965 activity may respond by not selling his equity shares in Company B as he would have before Company A’s share repurchase. In addition, it is difficult to determine what share repurchases or dividend increases would happen in the absence of section 965, as some companies would proceed with these activities by finding funding elsewhere.

8 The term “location preference” is used broadly here to indicate opportunities that a firm has to generate foreign-source income, and as such the term is not restricted to the conventional notion of brick-and-mortar investment.
for U.S. tax purposes of certain types of income as a result of projections of how companies will use qualified repatriations; and (4) changes the prospective investment and income location decisions by companies.

In preparing these estimates, we have examined the last two decades’ tax, accounting, and other economic data with respect to investment location decisions of U.S.-based multinationals, deferral of foreign source income, and financial reporting decisions. The trend towards overseas location of highly profitable investment (some of it associated with the transfer or development of intangibles) continues, as does the deferral and accumulation of foreign earnings (with the exception of the short-term drawdown of that accumulation caused by the enactment of section 965 in 2004). Some of this high overseas profitability is related to overseas marketing and production opportunities aimed at sales to third parties located overseas which is part of a secular movement that has been underway for many decades, while some of it can be linked to U.S.-based activities such as research and development or third-party demand in the U.S. market.

It is clear that companies have some latitude with respect to prospective location decisions. Changes over the last two decades in Treasury Department regulations (some favorable to overseas investment, e.g., the check-the-box regulations in the 1990s, and some at least potentially restrictive on overseas investment, such as the recent cost sharing regulations addressing transfer pricing methodologies and the subpart F contract manufacturing regulations) and the Code (e.g., the subpart F exception for active financing income which has been available over the last 15 years, and the provision in the Tax Increase Prevention Act of 2005 that allows taxpayers to avoid generating subpart F income from payments between related parties, known as the “CFC look through”) have on balance facilitated the deferral of foreign

9 For details about business structures that may facilitate income shifting or the deficiencies in the application of transfer-pricing rules, see Joint Committee on Taxation, Present Law and Background Related to Possible Income Shifting and Transfer Pricing (JCX-37-10), July 20, 2010.

10 For example, Mihir A. Desai and James R. Hines Jr., “Old Rules and New Realities: Corporate Tax Policy in a Global Setting,” National Tax Journal, LVII:4, (December, 2004), show the globalization over time of U.S. corporate profits in Figure 1, page 939.

11 While the Treasury Department has modified both its cost sharing and contract manufacturing regulations in recent years, we assume that taxpayers remain able to engage in planning to reduce their current income tax liability.
source income and reduction in the foreign taxes paid on such income. Potential U.S. residual taxation, while no doubt inhibiting the repatriation of the stock of deferred overseas earnings, also affects the prospective location decisions of firms to the extent that firms anticipate the need for repatriation of foreign earnings, as the investment location decision is linked to the repatriation decision.

Figure 1 summarizes the recent growth in deferral as context for evaluating the effects of your proposals. While the use of deferral has grown, companies continue to repatriate some dividends and as a result pay some residual U.S. tax in response to firm- or industry-specific exigencies. There is continuing demand for repatriation as the enactment of section 965 and subsequent interest in renewing section 965 have demonstrated. We expect repatriations to rise in the 2011-2021 budget period under present law as a result of the tension between domestic needs and the growth in the stock of deferred income.

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12 In recent years not affected by the original enactment of section 965, annual dividend repatriations have ranged from $50 to $100 billion. The Government Accountability Office, *U.S. Multinational Corporations: Effective Tax Rates are Correlated with Where Income Is Reported*, GAO-08-950, (August 2008), found that the residual U.S. tax rate on all foreign source income, of which dividend repatriation comprises under 25 percent, was about four percent. This aggregate average tax rate (which significantly is affected, for example, by “crosscrediting”, which is the netting of foreign taxes against foreign income across all foreign countries as permitted by the Code in certain circumstances), likely understates the potential U.S. tax collectible on marginal repatriations (which, for example, are less likely to be shielded from U.S. tax by cross-crediting).
Figure 1. Deferral as Share of U.S. Corporate Worldwide Income*

* Source: Statistics of Income Division, IRS. This is a flow concept, showing the relative amount of corporate income deferred every two years from 1994 to 2006. Worldwide income is defined as total receipts minus deductions, plus constructive taxable income received from related foreign corporations, plus CFC deferred income. CFC data before 2004 included above was from a restricted sample based on U.S. parent size. CFC data is for CFCs with net earnings and profits, and is before foreign (and U.S.) tax. Corporate income includes all U.S. subchapter C corporations with net income, before tax. There may be some time lag between the CFC and U.S. corporate income data because of fiscal year reporting differences.
Patterns in financial reporting also provide context for the revenue estimates, both technically (as a designation of permanently reinvested earnings, or PRE, is one way to qualify for exemption under section 965) and as a complement to the U.S. tax base changes presented above. A PRE designation is a book accounting assertion by a taxpayer that it will not be repatriating certain earnings back to the United States in the foreseeable future. This assertion often causes earnings for financial reporting to be larger than otherwise would be the case because after a PRE designation the taxpayer is not required to record the estimated U.S. tax charge that would accompany repatriation to the United States. A disadvantage for companies of a PRE designation is that it makes repatriation of the designated funds more difficult. The difficulty arises because a company that reverses a PRE designation reports to its shareholders a tax change reducing current year reported net income. (There is no commensurate reported increase in reported income because the company previously reported such income to its shareholders). Such a reversal may attract regulator and investor scrutiny. While this accounting treatment creates a difficulty for the company’s management, it does not make repatriation impossible. A taxpayer can override a designation under certain circumstances. Taxpayers also have some flexibility in making PRE designations: for example, previous PRE designations do not restrict taxpayers’ prospective choices about whether to repatriate or reinvest earnings generated in the future.

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\[13\] Because a company’s auditor, in compliance with the U.S. Generally Accepted Accounting Principles (“GAAP”), is required to evaluate evidence compiled by management (as well as any other relevant evidence) regarding management’s PRE assertion at each balance sheet date, a history of frequent PRE reversals may be considered negative evidence, thus hindering the auditor’s approval of any future PRE assertions made by management with respect to its audited financial statements. Moreover, such frequent reversals of PRE assertions could invite scrutiny from the Securities and Exchange Commission (“SEC”) because such reversals could be perceived as an attempt by management to manipulate its U.S. GAAP earnings through the income tax expense line item in its profit and loss statement. The result of such SEC scrutiny may be the issuance of an SEC comment letter, the required restatement of the company’s financials, or other possible sanction.

\[14\] For example, in 2009 Pfizer reversed its PRE assertion with respect to $34 billion in earnings that it intended to repatriate as part of its acquisition of Wyeth ($20.6 billion of the funds had been so designated by Pfizer and approximately $13.3 billion by Wyeth), according to Pfizer’s filing of Form 8-K on October 21, 2009, and Wyeth’s filing of its 2008 Form 10-K on February 27, 2009. Although Wyeth disclosed that the residual U.S. tax on Wyeth’s historic PRE was $2.7 billion or 20.3 percent ($2.7 billion divided by $13.3 billion), no similar level of detail was available with respect to Pfizer’s historic PRE. If one were to make the simplifying assumption that the U.S. residual tax rate was 20.3 percent on all $34 billion of the PRE designation that was reversed in this case, the accounting tax charge reflecting this PRE reversal would have been approximately $6.8 billion.
Our research finds PRE growth to have been very strong over the past decade. Cumulative PRE for 75 companies (chosen as the top 75 in a recent Fortune 100 list) showed this number growing from about $115 billion in 2000 to about $250 billion in 2005 (a number that would have been higher had it not been depleted by repatriations under section 965) and reaching over $700 billion by 2010.\textsuperscript{15} It is possible that some of the PRE growth after the expiration of the original section 965 occurred in anticipation of, or preparation for, expected impending extension of section 965. In any event, increased PRE designations raise the baseline amounts used for the estimates, and the large increase in PRE conflicts with companies’ public statements about the need to bring funds back to the United States that are now invested abroad. If companies keep adding to PRE but also continue to need those funds at home, then, in the absence of section 965 or some other exemption, one would expect that tension would resolve itself in favor of taxable dividend repatriations to the United States, as more income would be repatriated under present law\textsuperscript{16} and/or the incentive to locate income and investment offshore diminishes.

As a result of the above considerations, the revenue estimate pattern for both proposals shows that, in the first three years after enactment of each proposal, the revenue received by the United States associated with the induced repatriated dividends exceeds the two negative effects associated with each proposal, which were: (1) the U.S. tax effects on dividends that would have been repatriated during the budget period in the absence of the proposal; and (2) the proposal’s effect on prospective decisions about location of investment and income. However, the positive revenue associated with the application of section 965’s reduced U.S. residual tax to dividends

\textsuperscript{15} This growth in PRE has been noted by others. Following up on the description of section 965 electors in Susan Albring, Ann Dzuranin, and Lillian F. Mills, “Tax Savings on Repatriations of Foreign Earnings Under the Jobs Act,” \textit{Tax Notes}, August 8, 2005, the authors Lee A. Sheppard and Martin A. Sullivan, “Multinationals Accumulate to Repatriate,” \textit{Tax Notes}, January 19, 2009, showed that accumulated PRE for 40 large companies had by the end of 2007 recovered from repatriation under section 965 during the 2004-2006 period to reach about 200 percent of the 2002 PRE amount. Rodney P. Mock and Andreas Simon, “Permanently Invested Earnings: Priceless,” \textit{Tax Notes}, November 17, 2008, found that, for a sample of 81 large companies, about one half of the reduction in PRE owing to section 965 was restored (meaning that accumulated PRE was replenished) right after section 965 was elected by these taxpayers.

\textsuperscript{16} See discussion of Pfizer above for an example.
that would not have been repatriated in the absence of each proposal fades as the other two effects, and particularly the location effects, manifest.\footnote{It may be helpful to provide some context regarding the internationalization of the U.S. tax base in the later years of the budget period with reference to the location effects. The U.S. corporate tax in the later years of the budget period is anticipated to generate over $300 billion in net receipts per year, and foreign taxes credited against U.S. corporate taxes are projected to be between $75 and $125 billion annually. These magnitudes indicate both the globalization of U.S. companies, as noted above, and the scope of how a change in the treatment of foreign source income could alter U.S. corporate tax receipts.}

For estimating purposes, we see enactment of section 965 on a stand-alone basis as affording taxpayers some of the benefits (but none of the potential detriments) of a dividend exemption system: (1) taxpayers that prefer present law are not required to elect section 965; (2) taxpayers that elect section 965 can still avail themselves of cross-crediting (cross-crediting generally is eliminated or inhibited in formal dividend exemption systems) by “filling up the base”,\footnote{“Filling up the base” (where “base” refers to the historical average test for exemption under section 965) describes a taxpayer’s opportunity to identify which specific dividends qualify for exemption (foreign tax payments associated with such exempted dividends are disallowed for the purpose of calculating foreign tax credits). This choice permits the taxpayer to “cherry pick” to ensure that the DRD applies to repatriated foreign dividends that attracted modest foreign tax, thus preserving the use of dividends (i.e., not applying section 965 and its concomitant reduction in foreign taxes eligible for the foreign tax credit) that attracted higher levels of foreign tax for cross-crediting against non-dividend income such as royalties and interest. Evidence of the selectivity of filling up the base in Redmiles (2008, \textit{op. cit.}) shows that the overwhelming amount of qualified dividends came from foreign countries with low tax rates, which contrasts with the evidence that many section 965 electors were large U.S. multinationals (Mock and Simon, 2008, \textit{op. cit.}). These multinationals, according to their financial reports, tend to conduct activity in foreign countries with both low and high tax rates - thus, in the absence of the use of the permitted selectivity, one would have expected a more heterogeneous geographic (and perhaps industrial) mix in the character of the dividends that qualified for exemption under section 965.} and (3) the exempt portion of dividends under section 965 is subject to only minimal disallowance of U.S. deduction of directly allocable expenses incurred in the United States.\footnote{For 2004 through 2006, only about $600 million of expense was disallowed for deduction in the United States because it was directly allocable to the almost $300 billion of dividends qualified for exemption under section 965 (Redmiles, 2008, \textit{op. cit.}). This comparison to a dividend exemption system assumes that such a system includes some meaningful expense disallowance rules. Many dividend exemption systems in place in foreign jurisdictions do not have such rules, while some impose an exemption “haircut” as a proxy for expense disallowance.} Enactment of a stand-alone, temporary section 965 for a second time in a seven-year period likely signals to taxpayers that something like section 965 will become a periodic, if not a
permanent, feature of the Code. The foregoing aspects of your section 965 proposals would create a quasi-dividend-exemption elective system that would reside within the worldwide approach to taxation generally embodied in the present-law Code.

It is also important to consider some of the macroeconomic/stimulus issues related to extension of section 965. One would expect some positive U.S. tax base effects from the potential repatriation of about $700 billion for the 85-percent DRD proposal (of which about $200 billion is assumed by us to be accelerated repatriation that would have occurred in any case during the budget period under present law), or $325 billion in the case of the 70-percent DRD proposal (of which about $125 billion is assumed by us to be accelerated repatriation that would have occurred in any case during the budget period under present law),\(^\text{20}\) that we anticipate for these reenactments of section 965 (coming after the $300 billion of qualified repatriation for the original enactment of section 965), even if the dividend reinvestment stipulation in section 965 does not restrict taxpayers very much. Indeed, as noted above, we have included some tax base effects reflecting the usage of qualified repatriations under your proposals. However, at least thus far, the research has shown little macroeconomic benefit from the original enactment of section 965: this may be due to the difficulty in measuring these effects, or it may be due to how the repatriated funds were used, or it may be that a $300 billion repatriation barely registered in a U.S. economy with more than $10 trillion in 2005 of Gross National Product ($15 trillion in 2011). Aside from the general issue of measuring the initial impact of section 965 with respect to these effects, it is also necessary to recognize that, while section 965 facilitates the return of the stock of deferred earnings to the United States, prospectively it also encourages investment and/or earnings to be located overseas, and thus enactment of a stand-alone section 965 may curtail one distortion (repatriation) while enhancing another distortion (investment and earnings location). As a result, it would be necessary to look at the long-term macroeconomic aspects of each proposal and not just the early effects associated with the initial repatriation influx.

We note three interconnected factors that cause these estimates to differ from prior estimates of similar proposals (with the most recent estimate, from early 2009, of -$28.6 billion

\(^{20}\) This $200 billion for the 85-percent DRD proposal and the respective $125 billion for the 70-percent DRD proposal include some dividends that we assume would be repatriated under present law in the 2011-2021 budget period without any direct connection to a PRE reversal, and some dividends that we assume would be associated with PRE reversals we anticipate under present law in the 2011-2021 budget period.
for the fiscal year 2009-2019 period for an 85-percent DRD proposal).\footnote{21} First, as noted above, PRE designations are reported to have increased significantly, particularly in the past few years. Second, the macroeconomic assumptions on which we base our estimates have improved as the recent recession has abated, and this added projected corporate profit growth has raised the baseline projections of domestic and foreign earnings and investment that would be affected by a reenactment of section 965. Third, evidence of PRE reversal suggests that it is not unrealistic to assume that, under present law, some companies may be compelled to access profits in the United States either by repatriation or by changing prospective location of income-generating activity to the United States.

Finally, it may be helpful if we consider the interaction of proposals like yours with some broader tax reform ideas. As noted above, it is our view that each of your stand-alone proposals creates a system within a system, contributing to the overall negative revenue results presented above. This systemic conflict would be absent from a broader reform proposal that might be coupled with something conceptually like section 965 (but perhaps mandatory and with more than minimal expense disallowance) as transition in a major overhaul of how the Code treats foreign source income. As a result, the revenue estimate for something like section 965 that is enacted as part of a broader reform likely is different from the revenue results presented above for two proposals for a stand-alone section 965.\footnote{22}

\footnote{21} Statement by Senator Carl Levin, Congressional Record-Senate, February 3, 2009, page S1413.

\footnote{22} If a broad reform is accompanied by an elective version of section 965, the character of the reform will affect the incentive for taxpayers to repatriate accumulated deferred earnings at the time of transition to the new system. For example, both a dividend exemption reform, and a reform that retains present law while repealing deferral, likely would, for different reasons, reduce the incentive of taxpayers to elect section 965 as compared to the stand-alone 965 that you proposed above. A territorial regime would reduce this incentive because taxpayers would anticipate the future stream of dividends that could be repatriated without U.S. taxation (and perhaps little or no denial of a tax deduction for domestic expenses linked to the prospective dividends) under a territorial regime, so there might be less need by companies to repatriate the accumulated stock of earnings deferred under the present law worldwide regime which is to be replaced by the territorial regime. On the other hand, a reform that amends present law by repealing deferral also would permit taxpayers to repatriate, at no additional U.S. tax cost, prospective earnings that would already have been taxed by the United States as earned, and such repatriation of prospective earnings would, unlike repatriation under something like your proposals for a stand-alone section 965 with an 85-percent or 70-percent DRD as an increment to present law, incur no additional U.S. tax as repatriation of prospective earnings would by definition be considered by the United States to be previously taxed income.
Honorable Lloyd Doggett
U.S. House of Representatives

I hope this information is helpful to you. If we can be of further assistance in this matter, please let me know.

Sincerely,

Thomas A. Barthold