NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on the Effect of Mergers, Acquisitions and Dispositions on the Application of Code Section 965

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Report On the Effect Of Mergers, Acquisitions And Dispositions

On The Application Of Code Section 965

I. Introduction

This Report[1] addresses how various provisions of new Section 965[2] should be applied when the U.S. corporation (or U.S. consolidated group) seeking the Section 965 dividends-received deduction has been a party to a merger, acquisition or disposition (including a spin-off) (an **"Extraordinary Transaction"**) at any time during the period that is relevant to the Section 965 computations. We understand that the Treasury Department and the Internal Revenue Service intend to issue guidance on this subject in the very near future and we appreciate the opportunity to provide our views.[3] This Report recommends an interconnected set of proposed rules for how Extraordinary Transactions should impact the application of Section 965. These proposed rules are summarized in the Appendix to this Report.

We commend you for having issued Notice 2005-10[4] so promptly and for devoting so many resources to clarifying the application of this important, but temporary,

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[1] The principal author of this Report was Diana L. Wollman. Substantial assistance was provided by Kimberly S. Blanchard, Peter Connors, Joseph J. Czajkowski, Marc Ganz, Kevin Glenn, Deborah J. Goldstein, Martin T. Hamilton, David P. Hariton, Deborah J. Jacobs, Daniel J. Kheel, Joan Magnani, Thomas R. May, Douglas R. McFadyen, Stephen Mills, John Narducci, Yaron Reich, Elinore Richardson, Michael L. Schler, Andrew P. Solomon, Jonathan A. Stevens, and Linda Swartz.

[2] All Section references are, unless otherwise noted, to sections of the Internal Revenue Code of 1986, as amended.

[3] We previously submitted a comment letter to the Treasury Department and the IRS addressing the Section 965 requirement that repatriated funds be reinvested in the U.S. (This letter was reprinted in Tax Notes Today, Dec. 20, 2004, 2004 TNT 244-59.) We will be submitting a second Report, in the near future, addressing other issues raised under Section 965.

[4] Notice 2005-10, 2005-6 I.R.B. 1, primarily addresses the "domestic reinvestment" requirement under Section 965. This is the only administrative guidance relating to Section 965 that has been issued to date and it does not address the issues addressed in this Report.

Code provision. We realize that in order for this provision to serve its intended purpose (that is, for U.S. shareholders to repatriate funds from their controlled foreign corporations during the current taxable year that they would not otherwise repatriate), taxpayers will seek a high degree of certainty as to the amount of dividends for which the Section 965 deduction will be available. The provision will not be effective if taxpayers are not sufficiently confident of the manner in which it operates. Thus, the need for guidance is critical.

Section 965 permits a U.S. corporation to claim an 85% dividends-received deduction for certain dividends received from foreign subsidiaries during a one-year election period. As explained in more detail below, under Section 965 the amount of dividends eligible for the deduction is determined based upon three historical factors, as well as the amount of dividends actually paid in the relevant election year. The impact of Extraordinary Transactions on all four of these determinations is enormous, particularly when you consider how far back in time the statute looks in computing the historical amounts.

Part II of this Report describes how Section 965 works and summarizes the impact an Extraordinary Transaction could have on the Section 965 computations. Part III describes how the statute addresses the effect of Extraordinary Transactions on the Section 965 computations and discusses the Treasury Department's authority to issue guidance on the matter. Part IV addresses what we believe the goals and guiding principles should be for adjusting and allocating the historical amounts. Part V lays out the framework for our specific recommendations, by describing the template Extraordinary Transactions we considered. Parts VI and VII discuss our recommendations for how the three historical attributes might be adjusted on account of each "template" Extraordinary Transaction, and describes and evaluates the various alternatives that we considered. These recommendations are restated in summary form in the Appendix to this Report. Part VI also includes a discussion of what we view as anomalies and problems in the application of Section 965 as a result of the subpart F rules and Section 1248. In Part VIII we provide some additional recommendations relating to the upcoming guidance. Finally, in Part IX we note various issues that we believe may be raised in the case of specific taxpayers but as to which we have no specific recommendations at this time. These issues include certain questions concerning how the special spin-off allocation rule provided in Section 965(c)(2)(C)(ii) is intended to work.

While we have not addressed every possible factual scenario, we have based our proposals on a set of principles which we believe could be applied in situations that do not fit the "template" transactions we have addressed. Our proposals for the template transactions constitute a system of inter-related, bright-line rules which we believe are as consistent as possible. We recognize that, like most bright-line rules, they may not arrive

at a perfect result in every case, but, having considered the issues in detail, we believe bright-line rules are the best approach here.[5]

II. How Section 965 Works and The Impact That an Extraordinary Transaction Could Have on the Section 965 Computations

A. Background

Section 965 was enacted on October 22, 2004, as part of the American Jobs Creation Act of 2004,[6] and was described by Congress as a "temporary economic stimulus measure."[7] In a sweeping departure from the generally-applicable rules, Section 965 permits a domestic corporation that is a "United States shareholder" (as defined in Section 951(b)) (**"USSH"**) in a "controlled foreign corporation" (as defined in Section 957(a)) (**"CFC"**) to claim an 85% dividends-received deduction for certain cash dividends received by the USSH from its CFCs during a single taxable year.

The taxable year in which the deduction may be claimed is, at the USSH's election, either (i) the USSH's last taxable year which begins before October 22, 2004, or (ii) the USSH's first taxable year which begins after October 22, 2004. We refer to the year which the taxpayer elects as the **"Election Period"**.[8]

B. Computation of the Amount of Dividends Eligible for the Deduction

The computation of the amount of cash dividends received by the USSH during the Election Period eligible for the Section 965 deduction begins with the aggregate cash dividends received by the USSH from all of its CFCs during the Election Period. The portion of that aggregate amount that is eligible for the Section 965 deduction is determined by reference to three historical factors: (1) the base period distributions, (2) the APB 23 amount, and (3) any increase in related-party debt.

(1) Base Period Distributions Threshold (Dividends Must Be "Extraordinary")

First, the cash dividends eligible for the deduction are limited to the amount by which the aggregate cash dividends received by the USSH from its CFCs during the

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5 We also discuss below the possibility of an expedited private letter ruling process for certain types of cases.

6 Section 422 of The American Jobs Creation Act, P.L. 108-357 (2004).

7 House Comm. Rpt. No. 108-548, pt. 1, at 146.

8 The Section 965 election would be made by the common parent of a consolidated group and apply to the entire group. *See* Section 965(c)(5) and Treas. Regs. § 1.1502-77(a)(2)(i) (elections made by the common parent).

Election Period *exceeds* the annual average distributions received by the USSH from its CFCs over a five-year "base period," but excluding the year with the highest distributions and the year with the lowest distributions.[9] The five-years that are relevant for this purpose are the USSH's five most recent taxable years ending on or before June 30, 2003. If the USSH has fewer than five taxable years ending on or before June 30, 2003, all of its years ending prior to June 20, 2003, are included in its "base period," even if that includes four years.[10] We refer to the period of five (or fewer) years ending on or before June 30, 2003, as the **"Base Period"**.

The distributions during the Base Period that are take into account are (1) dividends, (2) amounts includible under Sections 951(a)(1)(B) (subpart F inclusions attributable to a CFC's investment in U.S. property pursuant to Section 956), and (3) distributions of "previously taxed income" (**"PTI"**) that are excluded from income under Section 959(a) (without duplication of distributions of amounts already included under item (2)). For convenience, we refer to these three types of distributions as **"Distributions"** and to the three-of-five year annual average as the **"Base Period Amount"**.

The purpose of the Base Period Amount threshold is to incentivize taxpayers to repatriate *more* than they otherwise would have. The Base Period Amount serves as a proxy for what the USSH otherwise would have received from its CFCs during its Election Period year, had Section 965 not been enacted. Only distributions that are "extraordinary" by reference to the Base Period Amount are eligible for the Section 965 deduction.

In order to determine which three years are included in the base period years, a taxpayer will need to know if the amount of distributions received during each of the five years in the Base Period are to be adjusted due to an Extraordinary Transaction. If the USSH has acquired or disposed of any CFCs during the period beginning with the first day of its Base Period and ending on the last day of its Election Period, then the Base Period Amount may not serve as an appropriate benchmark for determining whether cash distributions received during the Election Period are "extraordinary".

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[9] Sections 965(b)(2) and (c)(2)(A). Section 965 takes into account only distributions from CFCs as to which the U.S. corporate shareholder is a "United States shareholder". For convenience, in the remainder of this Report when we refer to a USSH's CFCs, we are referring only to CFCs as to which the USSH is a United States shareholder.

[10] In other words, where there are less than five years ending on or before June 30, 2003, no years are "kicked-out". There is no special rule providing for an adjustment where any year in the base period is shorter than 12 months.

(2) APB 23 Amount

The second limitation is that the cash dividends eligible for the Section 965 deduction may not exceed the greater of:

(A) $500 million; and
(B) the amount of earnings shown as permanently reinvested outside the United States (pursuant to Accounting Principles Board Opinion 23)[11] on the "applicable financial statement" which includes such USSH, or, where the applicable financial statement does not show such an amount but shows a specific U.S. tax liability attributable to such earnings, the tax liability shown dividend by .35.

We refer to the relevant amount as the **"APB 23 Amount"**.

The "applicable financial statement" is the most recently audited financial statement certified on or before June 30, 2003. If the financial statement which includes the USSH must be filed with the SEC, the applicable financial statement is the most recent such statement filed on or before June 30, 2003. The relevant financial statements therefore will cover a period that ends on a date prior to June 30, 2003. We refer to the relevant financial statement as the **"Financial Statement"** and the last day covered by those statements as the **"Financial Statement End Date"**.

For a USSH that has the calendar year as the taxable year, this will likely mean that the Base Period ends on December 31, 2002, the Financial Statement End Date is December 31, 2002, and the Election Period begins either on January 1, 2004 or, more likely, on January 1, 2005. Thus, in the simplest case, there will be a Base Period, a one-year Election Period, and an interim two-year period between the two – there could have been one or more Extraordinary Transactions during each of these periods.[12]

The purpose of the APB 23 Amount limitation is very similar to the purpose of the Base Period Amount threshold. Its primary purpose is to allow the Section 965 deduction only for distributions that otherwise would not have been made. It does this by limiting the one-time tax deduction to amounts that were, in fact, in CFCs with no intention of being repatriated as of the Financial Statement End Date. The APB 23

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[11] *See* Conference Committee Report, H.R. Conf. Rep. No. 108-766 ("Conf. Comm. Rpt."), at 315 (fn. 111) stating that the statute is intended to refer to the amount shown pursuant to Accounting Principles Board Opinion 23.

[12] In a more complicated case, there may be even more periods. Assume, for example, a taxpayer that has June 30 as its year end. The Financial Statement End Date will likely be June 30, 2002, the Base Period end date will be June 30, 2003, and the Election Period will be either July 1, 2004 through June 30, 2005, or July 1, 2005 through June 30, 2006.

Amount is intended to match up to the earnings that, but for Section 965, would remain in the USSH's CFCs indefinitely.[13]

Where the USSH has engaged in an Extraordinary Transaction at some point after the Financial Statement End Date and prior to the last day of the USSH's Election Period which results in the USSH no longer owning a CFC that had all or part of the USSH's APB 23 Amount, the APB 23 Amount as of the Financial Statement End Date will no longer match up with the amount of unrepatriated and "reinvested" earnings in the USSH's CFCs.

(3) Increase in Related Party Indebtedness Adjustment

The amount of cash dividends during the Election Period that may be taken into account under Section 965 is reduced by any increase in the amount of indebtedness of the USSH's CFCs owed to "related persons" as of the last day of the Election Period, compared to the amount of such indebtedness as of October 3, 2004.[14] To the extent the amount of such indebtedness has *increased*, the cash dividends received by the USSH from CFCs during the Election Period otherwise eligible for the Section 965 deductions are decreased. We refer to such related person indebtedness as **"RPI"**. For purposes of computing the RPI of a USSH's CFCs, all CFCs with respect to the USSH are treated as a single CFC.

The purpose of the RPI reduction is to prevent the USSH from claiming the deduction for dividends paid out of funds that were already in the United States – or, to put it another way, to insure that the statute causes the repatriation of funds that are located outside of the United States on October 3, 2004.[15] Thus, indebtedness of one CFC to a related CFC is ignored.

Where there has been an Extraordinary Transaction at any time after October 3, 2004, and on or prior to the last day of the USSH's Election Period and that transaction results in a disposition of a CFC with RPI or the acquisition of a CFC with RPI, the comparison of RPI as of October 3, 2004, to RPI as of the last day of the Election Period will not accurately measure whether there has been an increase in the total funds loaned to the USSH's CFCs by related persons during that period.

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[13] An APB 23 Amount that was in existence on the last day of the Base Period could have been distributed before the Election Period begins. Any such distribution would not impact the availability of the Section 965 deduction during the Election Period for cash dividends up to the APB 23 Amount.

[14] "Related person" is defined, for this purpose, as any person that is a related person, as defined in Section 954(d)(3), to the CFC.

[15] *See* Conf. Comm. Rpt. at 315.

C. Section 965's Grouping and Allocation Rules

The statute provides for certain grouping and allocation rules that are relevant in considering the impact of an Extraordinary Transaction.

First, for all purposes, the statute groups together all USSHs that are members of an affiliated group filing a consolidated return, and refers to the entire group as "one United States shareholder."[16] Second, the statute groups together all the CFCs owned by that one USSH, essentially treating them all as a single CFC.[17] Thus, the Base Period Amount threshold, the APB 23 Amount limitation, the RPI adjustment and the Election Period cash dividends computation will apply to all the members included in a consolidated return as if they were one USSH and will apply with respect to all of the group's CFCs as if they were one CFC.

The statute also includes two allocation/grouping rules relating to the APB 23 Amount and the alternative $500 million minimum amount.

Under the first rule, if the Financial Statement includes more than one USSH (i.e., more than one U.S. consolidated group), Section 965(c)(5)(C) provides that the APB 23 Amount on the Financial Statement "shall be divided among such shareholders under regulations prescribed by the Secretary."

Under the second rule, contained in Section 965(c)(5)(B), all corporations treated as a "single employer" under Section 52(a) are limited to a single $500 million minimum threshold, and that amount is to be divided amongst them under regulations prescribed by the Secretary.[18]

Thus, in light of these grouping and allocation rules, an Extraordinary Transaction that causes a change in the entities included in a consolidated group, the entities covered by the Financial Statement, or the entities that constitute a "single employer" could justify an adjustment to the Base Period Distribution history, the APB 23 Amount (or the allocation of the $500 million minimum), the RPI amounts, and the Election Period cash dividends.

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16 Section 965(c)(5)(A).

17 *See* Sections 965(a)(1), (b)(1), (b)(2) and (b)(3).

18 Very generally, corporations are treated as a single employer under Section 52(a) if they are connected by greater than 50% ownership.

D. Period of Time During Which an Extraordinary Transaction Could Impact the Section 965 Computations

The period of time over which an Extraordinary Transaction could impact the Section 965 computations is the period that begins with the first day of the Base Period (the fifth most recent taxable year ending on or before June 30, 2003) and ends with the last day of the Election Period (i.e., the taxpayer's taxable year that includes October 22, 2004, or the following year).[19] For example, in the case of a calendar year taxpayer that elects for its 2005 taxable year, this would cover the 8-year period from January 1, 1998, through December 31, 2005.[20]

III. What the Statute Provides with Respect to Allocating Attributes Following an Extraordinary Transaction; Treasury's Authority to Issue Guidance

A. Allocation Rules Included in Section 965

The statute itself provides very little guidance on the allocation of attributes in the event of an Extraordinary Transaction.

There is one special rule (in Section 965(c)(2)(C)(ii)) for the determination of Base Period Distribution history where one domestic corporation (**"Distributing"**) spins-off another domestic corporation (**"Controlled"**) in a Section 355 spin-off during the Base Period. This rule provides that if Controlled is a USSH in any specific CFC, (1) Controlled will be treated as being in existence during the period Distributing is in existence,[21] and (2) if either Distributing or Controlled (or both) is a USSH in that CFC immediately after the spin-off, the Base Period Distributions from that CFC shall be allocated between Distributing and Controlled "in proportion to their respective interests as United States shareholders" of such CFC immediately after the spin-off. Thus, this rule assigns the Base Period Distribution history attributable to a particular CFC based upon the two USSHs' respective interests in that CFC immediately after the Extraordinary Transaction (and not based upon which of the two actually received the Base Period Distributions).

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19 Extraordinary Transactions that take place during the Election Period and in the years following the Election Period may also be relevant to the determination of whether the taxpayer has satisfied the domestic reinvestment requirement of Section 965(b)(4). That is one of the issues we will be addressing in our upcoming Report. This Report addresses only the determinations that must be made under Sections 965(a) through (b)(3).

20 For a taxpayer with a June 30 year-end and which elects for its year beginning July 1, 2005, the relevant period would extend from July 1, 1998 through June 30, 2006.

21 Presumably this is intended to mean that Controlled will be treated, for purposes of computing Controlled's Base Period Amount, as having been in existence during the preceding portion of Distributing's Base Period.

The statute's only other specific reference to Extraordinary Transactions is in Section 965(c)(2)(C)(i). Paragraph (c)(2) of Section 956 is titled "Base period years." Subparagraph (c)(2)(C) is titled "Mergers, acquisitions, etc." and subparagraph (i) reads:

> "In general. Rules similar to the rules of subparagraph (A) and (B) of section 41(f)(3) shall apply for purposes of this paragraph [i.e., paragraph (c)(2)]."

The Conference Committee Report refers to the special rule for spin-offs described above and then provides that "in other cases involving companies entering and exiting corporate groups, the principles of Code section 41(f)(3)(A) and (B) apply."[22]

As described in more detail below (in Section III.C), Section 41 provides for the research and development tax credit, and Sections 41(f)(3)(A) and (B) address the computation of that credit where the taxpayer has disposed of, or acquired, all or a portion of a trade or business during the period relevant to the computation.

B. Questions Raised By Section 965's Allocation Rules

Because Section 965's reference to Section 41(f)(3) is under the paragraph addressing the determination of the base period years, and because the statute contains a special rule for allocating Base Period Distribution history following a tax-free spin-off that occurs during the Base Period, several questions might be raised as to Treasury's authority to provide for other adjustments to the relevant Section 965 computations.

First, does the special rule for spin-offs, combined with the reference, in Section 965(c)(2)(C)(i), to Section 41(f)(3)(A) and (B) for *all other transactions*, mean that the rules that Treasury promulgates under Section 965(c)(2)(C)(i) may not be based upon the same principles as the special rule for spin-offs?

Second, because the statute specifically refers (in these two provisions) to the adjustment of a USSH's Base Period Distribution history in the event of an Extraordinary Transaction, does that mean that the Base Period Distribution history is the *only* Section 965 attribute that is to be adjusted in the event of an Extraordinary Transaction?

Third, because the spin-off rule refers only to transactions occurring *during the Base Period*, and the Section 41(f)(3) reference is under the paragraph addressing the determination of the Base Period years, does that mean that in the event of an Extraordinary Transaction *after* the Base Period, there can be no adjustments to Base Period Distribution history, or any other Section 965 attribute?

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[22] Conf. Comm. Rpt. at 315. While the statute refers to the "rules" of Sections 41(f)(3)(A) and (B), the Conference Committee Report refers to "the principles" of those sections.

Fourth, more specifically, do the special rules in Section 965(c)(2)(C)(ii) for tax-free spin-offs that occur *during* the Base Period mean that Treasury could not use those same rules for a tax-free spin-off that occurs *after* the Base Period?

Fifth, does the special rule for tax-free spin-offs mean that the same rule could not be used for allocating attributes other than Base Period Distribution history?

The special rules in Sections 965(c)(5)(B) and (C) for allocating the APB 23 Amount and the $500 million minimum amount raise similar questions. The authority given to Treasury in these sections raises the question of whether these are the *only* circumstances under which Treasury can allocate the APB 23 Amount shown on an applicable financial statement, or the $500 million minimum, amongst more than one U.S. consolidated group.

The rule in Section 965(c)(5)(C) seems clearly to have been intended to apply where the domestic corporations covered by the Financial Statement constituted more than one consolidated group *during the period covered by the Financial Statements.* It is possible, however, to read that section as also applying to a situation where the corporations included in the Financial Statement were members of a single consolidated group during the period covered by the Financial Statement, but cease to be members of the same group (as the result of an Extraordinary Transaction) prior to or during their respective Election Periods.

In applying the rule in Section 965(c)(5)(B), it is not clear what would happen if corporations that were a single employer on their Financial Statement End Dates ceased to be a single employer (as the result of an Extraordinary Transaction) prior to or during their respective Election Periods. If the APB 23 Amounts shown on their Financial Statements were, in the aggregate, less than $500 million as of the Financial Statement End Date, they would have to share the $500 million. If, however, a subset of the corporations were spun-off or sold prior to their Election Periods, would each of the two resulting consolidated groups then be able to claim the $500 million threshold? The operation of this rule in such a case is not clear because the rule does not specify the time at which the "single-employer" determination is made.

C. The Section 41(f)(3)(A) and (B) Rules

Section 41 allows a taxpayer a research and development tax credit, the amount of which is determined by looking at certain research expenditures made by the taxpayer during a historic multi-year period, and the gross receipts of the taxpayer during two different historic multi-year periods.

Section 41(f)(3)(A) provides that if the taxpayer has acquired the major portion of a trade or business (or of a separate unit of a trade or business) during any of those historic periods, the acquiror will inherit the expenditures and gross receipts of the transferor that were attributable to the acquired trade or business (or portion of such trade

or business). The principle here is that the trade or business (or separate unit thereof) that generated the historic amounts takes those amounts with it when it is transferred from one taxpayer to another. The legislative history to Section 41(f)(3)(A) and (B) explains that such adjustments are necessary so that the taxpayer's historic amounts are neither overstated nor understated relative to the businesses conducted by the taxpayer during the current taxable year.[23]

Section 41(f)(3)(B) provides that the transferor may reduce its historic-period expenditures and gross receipts by the amounts that were transferred to the acquiror, but only if the transferor provides the acquiror with the relevant information. Thus, the second principle is that no amounts should be lost and no amounts should be duplicated; and, as a corollary, that the transferor and acquiror must share the necessary information, thus insuring that no amounts are lost or duplicated, in order to claim the adjustments.

D. Our View of Treasury's Authority to Issue Extraordinary Transaction Guidance

We believe Treasury has broad authority in this area to promulgate the guidance that it considers necessary and appropriate to facilitate the application of Section 965 in the manner intended by Congress, provided such guidance is not inconsistent with the statute.[24]

In addition to the general grant of rulemaking authority under Section 7805(a), Treasury has broad authority under Section 1502 to issue regulations covering any matter involving corporations that file a consolidated return. This is relevant to Section 965 in particular because Section 965 specifically provides that all of the members of a consolidated group will be treated as a single USSH for purposes of applying the section. In fact, at the same time as Congress enacted Section 965, it reaffirmed Treasury's authority under Section 1502 by adding a new final sentence to Section 1502. That

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[23] Senate Comm. Rpt. No. 97-144 at 84-86.

[24] We are not troubled by fact that Section 965 includes no general grant of authority to issue all regulations deemed necessary. Congress has already provided such authority in Section 7805(a). We also believe that it is not a constraint that the version of Section 965 that passed initially in the Senate provided that "For purposes of this section [(i.e., the entire Code section)] – Rules similar to the rules of section 41(f)(3) shall apply in the case of acquisition or dispositions of" CFCs occurring at any time after the first day of the Base Period." (See Sec. 231(c)(5) of The Jumpstart Our Business Strength (JOBS) Act, 5.1637 108th Cong. (2004). We do not believe that the fact that the final bill did not include that provision, and instead followed more closely the version that passed in the House initially, should be read to mean that Congress intended to limit Treasury's authority in promulgating rules under Section 965.

sentence provides that Treasury "may prescribe rules that are different from the provisions of chapter 1 that would apply if such corporations filed separate returns."[25]

This addition to Section 1502, combined with the Committee Reports explaining it, clearly show that Congress intended to give Treasury expansive authority to provide how a consolidated group's tax liability is "determined, computed .. and adjusted, in such manner as clearly to reflect the income-tax liability and the various factors necessary for the determination of such liability"[26]. We believe this is further support for Treasury to issue guidance under Section 965 with respect to Extraordinary Transactions (whether they involve the group acquiring or disposing of a member or of a CFC).

We do not believe that the reference to Sections 41(f)(3)(A) and (B) constrains Treasury to implement rules under Section 965 that are identical to Section 41(f)(3). We believe that approach is not feasible as a practical matter, since Section 965 requires a number of computations for which there is no corollary under Section 41(f). Similarly, we do not believe that the fact that the statute provides a special rule for spin-offs and refers to Section 41(f) for "all other cases", or the fact that the reference to Section 41(f) is in the paragraph addressing the base period, constrains Treasury from applying the principles of the spin-off rule to other types of transactions, transactions occurring after the Base Period, and to attributes other than Base Period Distribution history.[27] This leaves it to Treasury to determine how the Section 41(f)(3)(A) and (B) principles apply to the Base Period Amount, and how these principles (or others) might apply to the other Section 965 historic amounts.

The general principle of Section 41(f), that the attributes go with the trade or business that generated them, leaves open the question of whether the various Section 965 amounts attach to (1) the CFC, (2) the direct USSH in the CFC, or (3) the consolidated group of which the direct USSH is a member. Sections 41(f)(3)(A) and (B) assign the historic amounts generated by any trade or business to the U.S. taxpayer that owns that trade or business during the year for which the credit is claimed. When the trade or business is transferred, the historic attributes go with the trade or business. This could been seen as suggesting that in applying these principles under Section 965, the relevant amounts should be transferred whenever the CFC that generated them is

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[25] Section 844 of The American Jobs Creation Act of 2004, P.L. 108-357.

[26] Section 1502 (first sentence).

[27] In fact, the special spin-off rule was added to the provision in Conference, whereas the reference to the principles of Section 41(f)(3) was in the versions passed initially in both the House and Senate. It is quite possible to view the spin-off rule as nothing more than clarification of the result that application of the Section 41(f) principles would arrive at in the case of a spin-off during the Base Period. We think there is no indication that it was added because Congress had determined that the application of Section 41(f) principles to such a spin-off would have led to a different result.

transferred. As discussed in more detail below, however, we believe it is more consistent with the overall structure of Section 965 generally if Section 965 attributes are transferred only when a USSH holding the CFC stock is transferred.

Finally, we do not believe that the inheritance of Section 965 attributes should occur only when an acquisition is subject to Section 381. Accordingly, we do not think it is necessary for you to resolve whether Section 965 attributes are attributes that would be subject to Section 381.

IV. The Goals and Guiding Principles of Allocation Rules

A. Goals of Allocation Rules

In considering the issues raised by Extraordinary Transactions and potential solutions to those issues, we think it should be a goal that the taxpayers involved in an Extraordinary Transaction, taken together, neither lose anything nor gain anything as a result of the Extraordinary Transaction. We believe that the purposes of Section 965 will be best served if the rules enable and require taxpayers to preserve their Section 965 attributes (both the ones that benefit a taxpayer as well as the ones that are a detriment). We believe that this is consistent with the principles of Section 41(f) and is appropriate as a policy matter.

Any adjustment and allocation rules should be consistent with the statutory scheme and fair to the taxpayers involved. The rules should be simple and straightforward enough to be understood by taxpayers, and to be applied consistently and with a high degree of certainty by taxpayers and the government.

Finally, we believe that the rules should not expose the government to the risk of being whip-sawed - - for example, where attributes that benefit taxpayers could be duplicated or attributes that are detrimental to taxpayers are inappropriately eliminated.

We recognize that our proposals do not achieve, in all cases, the first goal stated above. Nevertheless, we believe that overall our proposals achieve each of the various goals to the greatest extent possible.

B. Guiding Principles

We believe that the principles applied in determining the effect of Extraordinary Transactions on the various relevant Section 965 amounts should be as consistent as possible. Thus, for example, even if the statute were read to say that Section 41(f)(3)(A) and (B) principles apply only to determination of Base Period distributions, we believe that the same principles should be applied to other Section 965 determinations. We believe for the computations to work together in the manner intended by Congress (and to prevent taxpayers from losing an intended benefit and to safeguard the government against whip-saw) adjustments should be made in a consistent manner.

With that in mind, we believe the guiding principles should be as follows.

First, if a USSH's Base Period Amount and APB 23 Amount are to be adjusted on account of an Extraordinary Transaction, the amounts should be adjusted in tandem and consistently.

Second, the attributes of (and any distributions paid by) any entity that was in one group during that group's Election Period should be ignored in any other group's election period, even if the entity did not receive or pay dividends during the first group's Election Period.

Third, subject to the second principle, in the case of an acquisition by a USSH prior to its Financial Statement End Date, the USSH should not be barred from taking dividends paid by the acquired entities during its Election Period into account for Section 965 purposes.

Fourth, any Extraordinary Transaction that occurs after a USSH's Financial Statement End Date should not make it more difficult for the USSH to claim Section 965 benefits with respect to CFCs that it owned both on the Financial Statement End Date and during its Election Period.

Fifth, any Extraordinary Transaction that occurred prior to the USSH's Financial Statement End Date should give rise to an adjustment to the USSH's Base Period Amount, such that the Base Period Amount reflects the same CFCs that are reflected in the APB 23 Amount shown on the Financial Statement.

Sixth, if an entity is in a group during that group's Election Period (and not barred from participating in that group's Election Period), it must have a beginning RPI amount computed and an ending RPI amount computed (even if the computed amount is zero). And, as a corollary, if an entity is not in a group during that group's Election Period or is in the group but barred from participating in that group's Election Period, its RPI amount (if any) must not be counted in the group's beginning or ending RPI.

Seventh, taxable and tax-free transactions should be treated the same way.

Finally, Base Period distribution history and the APB 23 Amount belong to the transferred group when an entire group is acquired. When any USSH in a group leaves the group, the USSH takes with it the amounts attributable to each CFC that it takes with it. Where the USSH leaves the group without any CFCs, its takes no attributes. When a CFC is sold, its attributes are either eliminated or retained by the transferor group, but the attributes never go with the CFC into the acquiring group.

V. Extraordinary Transactions We Are Addressing

We have broken down our analysis and suggestions based upon certain "template" transactions, which we believe are the most common. In each case, the

taxpayers at issue may have engaged in any combination of these transactions. We suggest a specific rule for each single transaction and intend that where multiple transactions occur, each specific rule is applied to each of the specific transactions (which may lead to several adjustments to the amounts taken into account under Section 965). We recognize that there may be taxpayers who have engaged in transactions during the relevant time periods that do not fit within any of the template transactions. We believe, however, that the general principles behind the template rules could be applied to other transactions.

-- *The Targets We Posited*

We posited three levels of potential targets:

"Parent-T": a U.S corporation that is the "parent" of a consolidated group of corporations (within the meaning of Section 1501(a)) (the **"Parent-T Group"**) where there is at least one member of the consolidated group that is a USSH of a CFC.

"USSH-T": a member of the Parent-T Group and a USSH in a CFC.

"CFC-T": a CFC owned by a member of the Parent-T Group, which member is a USSH in CFC-T.

-- *The Acquirors We Posited*

We posited a single generic acquiror:

"Parent-A": could be (1) a U.S. consolidated group (the **"Parent-A Group"**), (2) a single U.S. corporation or (3) a CFC that is owned by a USSH that is a domestic corporation. Our suggestions, set forth below, would be the same if the acquiror is a U.S. corporate member of the Parent-A Group or a CFC owned by a U.S. member of the Parent-A Group.

-- *Template Extraordinary Transactions We Considered*

We considered four template Extraordinary Transactions:

(1) Parent-T is acquired by Parent-A, by taxable purchase of shares of Parent-T or by tax-free reorganization.

(2) USSH-T is acquired by Parent-A, by taxable purchase of shares of USSH-T (without a Section 338 election) or by tax-free acquisition.

(3) CFC-T is acquired by Parent-A, by taxable purchase of shares (with or without Section 338 election) or by tax-free acquisition. This includes an acquisition of USSH-T where there is a Section 338 election such that USSH-T is treated as selling, and Parent-A

Group is treated as acquiring, CFC-T directly (or where there is a tiered Section 338 election such that both USSH-T and CFC-T are treated as selling all of their assets).

(4) USSH-T is disposed of by Parent-A and USSH-T becomes a stand-alone corporation or parent of a new consolidated group (e.g., a spin-off or a sale to someone other than a U.S. corporation) by means of a taxable transaction or by means of a tax-free spin-off, split-off or split-up.

If a consolidated group is acquired in a transaction that qualifies as a reverse-acquisition under Treas. Regs. § 1.1502-76(d)(2), then the group that continues should be treated as the acquiring group for purposes of applying the adjustments to the Section 965 amounts.

As you will see in our proposals below, we would treat a disposition of USSH-T in the same manner as a spin-off of USSH-T (or an acquisition of USSH-T such that it does not become a member of a pre-existing consolidated group).

VI. Effect of Extraordinary Transactions on Base Period Amount and on APB 23 Amount (Including on the Allocation of the $500 Million Minimum)

A. Introductory Discussion

We address first whether Parent-T Group's and Parent-A's Group's Base Period Distributions and APB 23 Amounts should be adjusted on account of an Extraordinary Transaction. Generally, we believe that these two attributes should be treated consistently in the case of each type of Extraordinary Transaction.

The Base Period Amount is used as a reference point to determine when the cash dividends received during the Election Period exceed what the USSH would likely have received, based on past practice, had Section 965 not been enacted. As explained above, the Base Period Amount is the annual average Distributions received by the members of the consolidated group from all of its CFCs in the aggregate during the group's Base Period. This is compared to all cash dividends received by members of the consolidated group from its CFCs during the group's Election Period. The Base Period for each group will end on or before June 30, 2003, and the Election Period will not begin until some time in 2004 or, more often, 2005.

The question here is whether Parent-T Group's and Parent-A Group's Base Period Distribution history[28] should be adjusted for an Extraordinary Transaction that occurred

[28] The Base Period is determined by looking at the five years ending on or before June 30, 2003, and then kicking out the year with the highest Distributions and the year with the lowest Distributions. Thus, an adjustment to the Base Period Distributions may not change either group's Base Period Amount at all or conversely may change it dramatically.

after the group's Base Period started and on or before the last day of its Election Period. Such a transaction could occur, on the Parent-T side (1) during Parent-T Group's Base Period, (2) *after* Parent-T Group's Base Period but prior to Parent-T's Election Period, or (3) during Parent-T Group's Election Period.[29]

The APB 23 Amount is used to determine the amount of earnings in the USSH's CFCs that would not otherwise have been repatriated. As explained above, the APB 23 Amount is determined as of the Financial Statement End Date, which will be some date prior to June 30, 2003, even though the USSH's Election Period will not begin until 2004 or 2005.

The question here is whether Parent-T Group's and Parent-A Group's APB 23 Amounts should be adjusted for an Extraordinary Transaction that occurred some time after either group's Financial Statement End Date and on or before the last day of either group's Election Period.[30] Such a transaction could occur (1) after both group's Financial Statement End Dates, (2) after Parent-T Group's Financial Statement End Date but prior to Parent-A's Financial Statement End Date, or (3) prior to Parent-T's Group Financial Statement End Date but after Parent-A Group's Financial Statement End Date. Where the transaction occurs after both group's Financial Statement End Date, it could be (1) prior to both group's Election Periods, (2) during both group's Election Periods or (3) during one group's Election Period and prior to the other group's Election Period.

To answer both of these questions, we think it is important to consider the purposes of the Base Period Amount threshold and APB 23 Amount limitation. The goal

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[29] Looked at from the perspective of both groups simultaneously, the transaction could occur (1) during one group's Base Period but prior to the other group's Base Period, (2) during both group's Base Periods, (3) during one group's Base Period but after the other group's Base Period, (4) after both group's Base Periods and prior to both group's Election Periods, (5) during one group's Election Period but prior to the other group's Election Period, or (6) during both group's Election Periods.

[30] We understand that audited financial statements prepared in accordance with U.S. GAAP show an amount of earnings permanently reinvested outside the United States only if the shareholder makes an affirmative designation (or election) pursuant to Accounting Principles Board Opinion 23, and that this is done separately for each CFC. Similarly, where the financial statements show a deferred tax liability for such earnings, the taxpayer should have sufficient back-up to the financials to be able to determine the amount allocable to each of its CFCs. Accordingly, it is possible to determine the precise portion of Parent-T Group's aggregate APB 23 Amount attributable to any particular CFC that leaves the Parent-T Group after the Financial Statement End Date (whether it leaves with its USSH or alone). Where the Parent-T Group has no APB 23 Amount, we suggest below a way in which to determine the portion of the $500 million minimum that should be allocated to each CFC in the event of certain Extraordinary Transactions that we think should result in such an allocation.

of Section 965 is to incentivize USSHs to bring cash out of CFCs and back into the United States. We believe that the primary purpose of these two limitations is to allow the dividends-received deduction only for distributions that otherwise would not have been made. The Base Period and APB 23 Amounts essentially provide two ways of determining the amount of distributions that would not otherwise have been made. First, the USSH must receive *more than* it historically has been receiving; and second, the total for which the deduction is claimed may not exceed the amount of actual earnings that it had offshore without the intent to repatriate, as of its Financial Statement End Date.

The APB 23 Amount limitation could also be viewed as intending to match up the availability of the deduction with the CFCs' capacity to pay dividends. While we believe that was in part how the provision was initially conceived, as explained below the statute does not provide for a perfect "match" of the amount of dividends eligible for the deduction and the actual amount of cash (or unrepatriated earnings) available in any specific CFC for distribution.[31]

First, it is possible that a CFC's APB 23 Amount could have been distributed some time after the Financial Statement End Date and prior to the first day of the Election Period. It is even possible for such a distribution to have occurred during the Base Period (because the Financial Statement End Date might precede the last day of the Base Period).[32] It is unlikely that any such distribution would have occurred in the ordinary course, but if Parent-T, USSH-T or CFC-T was acquired during one of the relevant periods in an Extraordinary Transaction the earnings may have been distributed in advance of or as part of the transaction.

Second, a distribution from a CFC qualifies without regard to whether the distribution is from the specific CFC with the APB 23 Amount.

Third, a CFC could fund a distribution with borrowings, provided the borrowings are not from a related person other than another CFC owned by the same USSH.

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[31] This is due, in part, to the fact that, although the provision was not enacted until October 2004, it had been introduced over a year earlier. In order to prevent taxpayers from manipulating their historic reference amounts, Congress referred back to events prior to June 30, 2003, in determining the Base Period and APB 23 Amounts. It is also due, in part, to the provision's CFC aggregation rule which treat all the USSH's CFCs as a single CFC.

[32] The Financial Statement End Date might precede the last day of the Base Period because the Financial Statement End Date is the last day of the taxable period covered by the taxpayer's financial statements that were certified on or before June 30, 2003, whereas the Base Period is the five years ending on or before June 30, 2003. For example, a taxpayer that has a June 30 year would have a Financial Statement End Date of June 30, 2002, and a Base Period that ends on June 30, 2003.

Fourth, the earnings and profits out of which a qualifying dividend are paid do not need to be earnings and profits that had accumulated as of the Financial Statement End Date. Thus, earnings and profits accumulated in years subsequent to the period covered by the Financial Statement End Date, including the Election Year, could qualify.

Fifth, the statute provides for an alternative $500 million threshold amount for any taxpayer that has no stated APB 23 Amount or that has an APB 23 Amount that is less than $500 million.

Similarly, the statute does not match up the Base Period Distributions to the Election Period cash dividends on a CFC-by-CFC basis. Instead, it compares the aggregate amounts received by the USSH from all its CFCs during the two periods. Thus, the Base Period Amount limitation does not require that each specific CFC make distributions during the Election Period that exceed that particular CFC's Base Period average distributions.[33] In fact, the statute does not even require that the Election Period cash dividends be paid from CFCs that were in existence during the Base Period or on the Financial Statement End Date.

We think the foregoing observations are relevant to the question of how Base Period Distribution history and APB 23 Amounts should be handled in the case of an Extraordinary Transaction. We think they illustrate that perfect symmetry (or tracing of earnings and distributions) was not and cannot be expected in applying Section 965, even when there are no Extraordinary Transactions during the relevant periods. Thus, even if there are no Extraordinary Transactions, the Base Period Amount and APB 23 Amount may not be appropriate indicators of what the USSH otherwise would have received (the Base Period Amount) and otherwise would not have repatriated (the APB 23 Amount).

We do, however, believe that where the composition of the group has changed during one of the relevant periods, an adjustment to Base Period and APB 23 Amounts may be appropriate.

The Base Period Amount is intended to serve as a proxy for what the USSH would have received in the ordinary course had Section 965 not been enacted. Thus, a Base Period Amount that reflects the ownership of a different mix of CFCs than the USSH owns during its Election Period would, we believe, justify an adjustment to the Base Period Amount, if done in a manner that is consistent with the statute, is fair to the taxpayers involved, and does not expose the government to a risk of being whip-sawed.

Similarly, the APB 23 Amount is intended to represent the maximum amount of earnings that the USSH had off-shore without the intent to repatriate as of the Financial

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[33] To put it another way, there is no tracing, either in determining whether the Base Period Amount threshold is satisfied or in determining if the distributions are made out of APB 23 Amount earnings.

Statement End Date and that still has off-shore and has the ability to repatriate during its Election Period. Thus, where the mix of CFCs owned by the USSH has changed between the Financial Statement End Date and its Election Period, we believe an adjustment to the APB 23 Amount (or, where applicable, the allocation of the $500 million minimum) would be appropriate, subject to the same constraints as mentioned in the preceding paragraph.

The fundamental questions that are raised are: whether the Base Period Distribution history and the APB 23 Amount should attach to the consolidated group as a whole, to the specific USSH that holds the CFC shares, or to the CFC; whether the answer should be the same for both attributes; whether the answer should differ depending upon when the Extraordinary Transaction occurs (during or after the USSH's Base Period, before or after the USSH's Financial Statement End Date, and before or during the USSH's Election Period); and, if so, what the cut-off dates should be.

The Base Period Distribution history could be viewed as something that belongs to the USSH because the statute groups all the USSH's CFCs together and applies the Base Period Amount threshold at the USSH level. Similarly, where the USSH is a member of a consolidated group, these amounts could be viewed as belonging to the group because the statute treats the group as a single USSH. The statute compares the USSH's (or the group's) Base Period Amount to the aggregate amount received by the USSH (or group) from all of its CFCs during the Election Period. Thus, it seems to be premised on the view that the USSH (or group) is the one controlling the CFCs' distributions and that the Election Period Distributions must exceed what the USSH (or the group) normally receives and not what each particular CFC normally distributes.

On the other hand, the Base Period history could be said to more properly be viewed as something that relates to *each* CFC individually, on the grounds that the historic dividend-paying history of the CFC is what gave rise to the Base Period Amount.

The APB 23 Amount issues are similar. The decision to show an APB 23 Amount on a financial statement is made by the USSH (or, where there is a group, the parent of the group) and here the statute also groups together all of the USSH's (or group's) CFCs, and does not require that the Election Period distributions be made by the specific CFCs with the APB 23 Amounts. Yet, the APB 23 Amount limitation is intended to limit the dividends for which the deduction is claimed to the total unrepatriated and "reinvested" earnings that are actually in CFCs owned by the USSH (or group) during the Election Period. The APB 23 Amount thus could be seen as belonging with the CFC that has those earnings and has "reinvested" them.

Overall, we believe that attaching the Base Period Amount and APB 23 Amount to the USSH that owns the CFC stock is most consistent with the statute because the statute aggregates the distributions received by the USSH from all its CFCs, both during the Base Period and during the Election Period, and aggregates the APB 23 Amounts for all the USSH's CFCs. Where the USSH is a member of a consolidated group, we believe that a portion of these amounts should go with any USSH that leaves the group holding

the shares of one or more CFCs. This is the principle that is the basis of the special rule for spin-offs during the Base Period (in Section 965(c)(2)(C)(ii)). We think it is a sensible rule, is consistent with the statutory scheme, and is similar to many of the existing consolidated return rules governing the allocation of attributes when a member leaves or enters a consolidated group.

As described in detail below, we believe this principle should generally be applied to both Base Period and APB 23 Amounts, and regardless of when the Extraordinary Transaction occurred, subject to some important variations when the Extraordinary Transaction occurs after certain cut-off dates. The rationale for these variations is discussed below. The cut-off dates that we believe are most consistent with the statute are Parent-T Group's Financial Statement End Date and Parent-A Group's Financial Statement End Date. Our rationale for using these cut-off dates is that an Extraordinary Transaction that occurs after a USSH's Financial Statement End Date should not make it more difficult for that USSH to claim the Section 965 benefits with respect to CFCs that it owns both on its Financial Statement End Date and during its Election Period.

An alternative cut-off date would be the last day of each group's Base Period. We are not recommending that date because the Base Periods will end, in most case, years prior to the Election Period and we believe it would not be consistent with the statute or appropriate as a policy matter to "freeze" the taxpayer's Section 965 benefits as of a date so far in advance of the date of enactment or the Election Period. Thus, as discussed in more detail below, we believe a taxpayer that acquires a USSH some time after the acquiror's Base Period has ended, but prior to the acquiror's Financial Statement End Date, should neither be required nor permitted to "ignore" that CFC and its Section 965 attributes.

For the reasons described below, we believe that these attributes should not go with a CFC when the shares in the CFC are sold by its USSH. We believe this will further the statutory intent to the greatest extent, that it is consistent with the reference to the principles of Section 41(f)(3)(B) and (C), and that it is consistent with the principles of the consolidated return regulations which generally attach the group's attributes to members of the group, but not to entities owned by the members which are not includible in the consolidated return.

In the remainder of this section, we set forth proposed rules for each Extraordinary Transaction and discuss our rationale for these proposals.[34] Consistent with the approach taken in Notice 2005-10, we have proposed bright-line rules that would provide certainty to taxpayers. As discussed in Part VIII below, we also propose that an expedited private letter ruling process be made available to taxpayers for whom these

[34] These proposed rules are restated in the Appendix to this Report.

rules would result in distortion of their historic amounts in a manner that is not consistent with the statue.[35]

We also considered whether there should be some adjustment or allocation of Election Period cash dividends in the event of an Extraordinary Transaction during a group's Election Period. Such a rule might make sense if an entity that is transferred is permitted to participate in two separate group's Election Periods. Because we are proposing that any entity that is in a group during that group's Election Period not be permitted to participate in any other group's Election Period, we are not proposing any adjustments to (or "sharing" between taxpayers of) Election Period cash dividends.

B. Parent-T is Acquired by Parent-A Prior to Parent-T's Election Period or Parent-T Makes No Section 965 Election

Proposed Rules:

1. General Rule – Full Inheritance:

Parent-A inherits Parent-T's Base Period Distribution history and APB 23 Amount (if any), adding Parent-T's amounts to Parent-A's amounts, whether the transaction is taxable or tax-free to the shareholders of Parent-T.[36]

2. Election-Out of Full Inheritance:

If the acquisition occurs after Parent-A's Financial Statement End Date, Parent-A may elect, in lieu of applying Rule 1, to inherit none of Parent-T's Base Period Distribution history and APB 23 Amount, in which case, none of the cash dividends received from the CFCs that were in the Parent-T Group may be taken into account by Parent-A during its Election Period.[37]

3. Special Rule Relating to APB 23 Amount Inheritance for Acquisitions Prior to Parent-A's Financial Statement End Date:

If the acquisition occurs prior to Parent-A's Financial Statement End Date (whether it is before or after Parent-T's Financial Statement End Date), Parent-A does not

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35 News reports indicate that Treasury has been considering such an idea.

36 If all of Parent T's assets were acquired in a taxable transaction (i.e., one to which Section 381 did not apply), the transaction would essentially be an acquisition of all of the USSH's in the Parent-T Group (assuming Parent-T holds all its CFCs through domestic subsidiary corporations). Under our proposal for allocation of Base Period and APB 23 Amounts where USSH-T is the target, the result of an acquisition of all of Parent-T's USSHs would be the same as the acquisition of Parent-T.

37 In other words, the Parent-A Group may elect into the treatment that would apply if Parent-T had been acquired during Parent-T's Election Period (which is discussed in the next section of this Report, Section VI.C) rather than prior to that period.

inherit any APB 23 Amount, but does inherit Parent-T's Base Period Amount. Parent-A may not, in this case, elect-out of inheriting Parent-T's Base Period Amount (because the acquisition by Parent-A occurred prior to Parent-A's Financial Statement End Date).

4. Special Rule for Acquisitions After Parent-A's Financial Statement End Date but Prior To Parent-T's Financial Statement End Date:

If Parent-A does not elect out of full-inheritance (under Rule 2 above), it either (a) inherits the APB 23 Amount shown on Parent-T's last pre-acquisition "applicable financial statement", or (b) computes an APB 23 Amount for the Parent-T Group's CFCs by averaging the APB 23 Amount shown on Parent-T's last pre-acquisition "applicable financial statement" and the APB 23 Amount shown on Parent-A's first post-acquisition "applicable financial statement" with respect to the Parent-T Group's CFCs.

5. Special Rules for Acquisitions Occurring After Both Groups' Financial Statement End Dates:

a. If one of the groups had an earnings-permanently invested-abroad amount and the other had a deferred taxes amount, the deferred taxes amount would be converted to a permanently invested-abroad amount (in the manner provided by the statute) and then the two amounts would be combined.

b. If one of the groups had an APB 23 Amount and the other had none, such that the minimum $500 million was the relevant amount for the latter group, Parent-A would be required to choose either the APB 23 Amount or the $500 million minimum. It could not combine the two.

c. If both groups had an APB 23 Amount of less than $500 million and would therefore both have used the $500 million minimum amount, the Parent-A Group may not combine the two $500 million amounts, although it may combine the two APB 23 Amounts. If the combined APB 23 Amount is greater than $500 million, the Parent-A Group may use that aggregate amount.

Discussion:

If Parent-T is acquired, we believe that full inheritance (subject to the election-out in Rule 2, which we discuss below) is appropriate since the two groups will form a single consolidated group during Parent-A's Election Period.[38] Full inheritance is consistent with the goal that attributes neither be lost nor duplicated. We recognize that, given the facts in any particular case, full inheritance may help taxpayers, or may help them in some respects and hurt them in others. This is illustrated by the following two examples:

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[38] We are assuming that if the acquisition is prior to Parent-T's Election Period, it will normally be prior to or during Parent-A's Election Period. We discuss below the odd situation where the acquisition occurs prior to Parent-T's Election Period, but after Parent-A's Election Period.

Example A: Parent-T Group has a Base Period Amount of 0 and an APB 23 Amount of $100 on its Financial Statement End Date, but at the time it is acquired (prior to its Election Period or during the year that would be its Election Period if it so elected) Parent-T has no unrepatriated earnings left in its CFCs. Thus, but for the acquisition, Parent-T could not make any use of its APB 23 Amount to claim the Section 965 dividends-received deduction. Parent-A Group has CFCs with unrepatriated earnings but an APB 23 Amount of 0 on its Financial Statement End Date, so but for the acquisition, Parent-A could not claim any Section 965 benefits. If the two combine and all of Parent-T Group's attributes are inherited, the combined group can match up Parent-T's APB 23 Amount with Parent-A's CFCs' unrepatriated earnings and claim the Section 965 dividends-received deduction for 100 of dividends.

Example B: Parent-T Group has a Base Period Amount of 0 and an APB 23 Amount of $100. Parent-A Group has a Base Period Amount of $100 and an APB 23 Amount of 0. If the two combine and all of Parent-T Group's attributes are inherited, the combined group must receive distributions of $200 to claim the $100 of Section 965 dividends that the Parent-T Group could have claimed had it not been acquired. On the other hand, the Base Period Distributions may be paid from Parent-A's historic CFCs.

The taxpayer favorable result in Example A and the mixed result in Example B could be seen as inappropriate, but we believe these are anomalies the statute creates by using a Financial Statement End Date which is years prior to the first date of the Election Period, and by allowing Election Period distributions to be received from any CFC owned by the USSH.

Base Period Distribution history inheritance would be relevant if Parent-T is acquired any time after the first day of its Base Period. If Parent-A does not make the election to ignore the Parent-T Group, the entire Base Period Distribution history would be inherited, even if the acquisition occurred during Parent-T's Base Period.[39]

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[39] Where the transaction occurs during (rather than after) Parent-T's Base Period we have not resolved the best way to determine which of Parent-T's pre-acquisition years should be the inherited years. The acquisition will end Parent-T's taxable year, creating a short pre-acquisition year and a short post-acquisition year. If those two short years equal 12 months (i.e., Parent-T and Parent-A had the same taxable year end), there would be no distortions – you would simply count the two short-years a single year. If, on the other hand, the two short years were longer than 12 months or shorter than 12 months, there could, depending upon the facts, be some distortion from counting the two short years as a single year or counting the pre-acquisition short-year as a single year. A similar problem could occur if the acquisition occurs after Parent-T's Base Period has ended, but during Parent-A's Base Period. If the Parent-T Group CFCs make Distributions during the Parent-A Base Period, then those CFCs would have been included in a Base Period that is longer than five years. These are matters that we believe would be best addressed by a private ruling request.

APB 23 Amount inheritance would be relevant only for acquisitions that occurred after both group's Financial Statement End Date and prior to the first day of Parent-T's Election Period.[40]

The election-out of full inheritance, for acquisitions that occur after Parent-A's Financial Statement End Date, will allow Parent-A to preserve the Section 965 benefits that it would have had, as of its Financial Statement End Date, had it not engaged in the subsequent acquisition. We believe this is consistent with the statute and is illustrated by the following example.

Example C: Parent-T Group has a Base Period Amount of 100 and an APB 23 Amount of 0. Parent-A Group has a Base Period Amount of 0 and an APB 23 Amount of 100 and it acquires Parent-T Group after Parent-A's Financial Statement End Date (before or during Parent-A Group's Election Period). If the election out of full inheritance were not available, Parent-A would be required to receive 200 of dividends during its Election Period in order to claim the Section 965 benefits for its APB 23 Amount. If Parent-A elects out of full inheritance, during its Election Period it may not take into account dividends from the Parent-T Group's CFCs.

The election out may seem unfair to some taxpayers in that it only permits the combined group to disregard the target group, as opposed to allowing the combined group to disregard either group. Take the following example:

Example D: The facts are the same as Example C, except reversed, so that Parent-A has the Base Period Amount of 100 and no APB 23 Amount, and Parent-T has a Base Period Amount of 0 and an APB 23 Amount of 100. Because Parent-A Group is the continuing group, it must satisfy its Base Period Amount of 100 prior to claiming the Section 965 benefits for Parent-T's APB 23 Amount.

We think this result is appropriate because the Parent-A Group is the continuing group and should not be able to shed its attributes solely because of an acquisition. A rule that permits Parent-A to do that would, we believe, be more susceptible to abuse than our proposal. In addition, if the acquisition has not yet occurred, it could be delayed to permit Parent-T to claim the Section 965 benefits prior to the acquisition.

Rule 3 clarifies that where the acquisition is prior to Parent-A's Financial Statement End Date, there is no APB 23 Amount inheritance, even if the acquisition occurs after Parent-T's Financial Statement End Date. There would be no need for APB 23 Amount inheritance, in this case, because Parent-A would own the acquired entities on its Financial Statement End Date.

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[40] If the acquisition occurs prior to Parent-T's Financial Statement End Date, there would be no APB 23 Amount to inherit.

Rule 4 addresses the problem that would arise if the acquisition occurred after Parent-A's Financial Statement End Date, but prior to Parent-T's Financial Statement End Date. In that case, the election to ignore Parent-T would be available, although this could be seen as unfair in that it would prevent any permanently reinvested abroad earnings in Parent-T's CFCs from being used in the manner intended by Section 965. Accordingly, in order to permit the combined group to take into account under Section 965 dividends from Parent-T's CFCs, we have proposed two alternative ways in which to compute an appropriate APB 23 Amount for those CFCs.

Rule 4.a which uses Parent-T's last pre-acquisition applicable financial statement, would be administrable and clear, but it may understate the earnings that would otherwise have been stated on Parent-T's Financial Statement End Date had it not been acquired. Using Parent-A's next following applicable financial statement might overstate those earnings since it would include some additional period of time, although how much time would depend upon the two group's year-ends and the acquisition date. Therefore, we are proposing Rule 4(b), which uses an average of the two amounts, and allowing Parent-A to choose between the two methods.[41]

The rationale for Rules 5.b and c is that although the statute refers back to the Financial Statement End Date in determining the benefits allowable to the taxpayer, neither Parent-T nor Parent-A was entitled to the $500 million minimum until the statute was enacted. Allowing taxpayers that combine after their Financial Statement End Dates to have two $500 million minimums simply because they combined after those dates, rather than prior to them, seems inappropriate. As the following examples illustrate, however, it may seem unfair to deny them the $1 billion aggregate amount simply because they combined, particularly if they combined after the statute was enacted on October 22, 2004.

Example E: Parent-T Group has no APB 23 Amount and Parent-A Group has a $700 million amount. Had they not combined, their aggregate APB 23 Amount threshold would have been $1.2 billion. After the combination, the threshold for the combined entities is only $700 million.

Example F: Parent T- Group has an APB 23 Amount of $400 million and Parent-A Group has an APB 23Amount of $200 million. Had they not combined, their aggregate APB 23 threshold would have been $1 billion (that is, two $500 million minimums), but together their threshold is only $600 million.

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[41] We considered proposing a time-weighted average, but that becomes complicated if the the two groups have different year-ends because it would not be clear which year-end should govern.

Example G: Both Parent-T Group and Parent-A Group have no APB 23 Amount. Had they not combined, their aggregate threshold would have been $1 billion, but together their threshold is $500 million.

In proposing inheritance of the full APB 23 Amount (if any), we considered the fact that Parent-T may have caused some of its APB 23 Amount to have already been distributed out of its CFCs prior to the acquisition, which would result in a mis-match between the inherited APB 23 Amount and the actual amount of unrepatriated earnings in its CFCs. We believe however that the statute already allows for that possibility even where there is no Extraordinary Transaction prior to the Election Period and, therefore, that such distributions should not change the results where the entire Parent-T Group is acquired.

We suggest that the Parent-A Group be permitted to elect to ignore all of the Section 965 attributes of the Parent-T Group (Rule 2) because of the distortions that could occur in the computation of both Base Period Amount and the APB 23 Amount for the combined group. We believe that non-inheritance should be elective and not required, because it would be inappropriate to require the combined group to ignore Election Period dividends from the Parent-T Group CFCs solely because the groups did not combine until after Parent-A's Financial Statement End Date. The benefits of Section 965 were essentially intended to be fixed as of that date and an Extraordinary Transaction after that date should not deprive the taxpayers involved of those benefits.

We believe that this election should be available, however, only where Parent-T is acquired after Parent-A's Financial Statement End Date. It would not be appropriate to allow Parent-A to ignore the Base Period Amounts of Parent-T's CFCs simply because they were acquired any time after the first day of the Base Period. In other words, some cut-off date is needed and the statute essentially uses the Financial Statement End Date as the cut-off for when the benefits of Section 965 are determined. Thus, we believe entities acquired prior to that date should not be ignored.

The type of distortions that the election-out would ameloriate are illustrated by the following.

Example H: Assume the Parent-T Group has a high Base Period Amount and the Parent-A Group has no Base Period Amount. Requiring Parent-A to use Parent-T's Base Period Amount could be seen as preventing Parent-A from claiming the Section 965 deduction for dividends that it otherwise would have paid from its CFCs, because after the combination Parent-A would have to exceed the inherited Base Period Amount.

This result might seem appropriate if the CFCs that contributed to Parent-T's Base Period have been acquired by Parent-A, but where the acquisition occurs prior to Parent-A's Financial Statement End Date, we believe that it is more consistent with the statute to permit the Parent-A Group to preserve the benefits it would have had but for the acquisition. While this scenario may be rare, allowing Parent-A to elect to ignore the

Parent-T Group for all Section 965 purposes seems like a simple and appropriate rule that should preserve the intended benefits of Section 965 to the greatest extent.

We have proposed inheritance of the Parent-T Group's Base Period Distribution history, as opposed to its Base Period Amount. If the acquisition occurred after Parent-T Group's Base Period had ended, it would be possible to require that the Base Period Amount be inherited instead of the Base Period Distribution history. We favor inheritance of the Distribution history, though, for several reasons.

First, if the acquisition occurred during Parent-T Group's Base Period, the inheritance would logically be of the Distribution history up through the acquisition date; and we believe that the inheritance rule should work the same way for acquisitions during and after Parent-T's Base Period. Similarly, if the acquisition occurs during one group's Base Period but after the other group's Base Period has ended, a special rule would be needed and we believe one consistent approach would be a better solution. Finally, given the statute's three-of-five year rule, and the fact that the two groups will be combined during their Election Period, it seems more appropriate to have the combined group compute a Base Period Amount based upon the combined Base Period Distributions.

As noted above (in footnote 39), there could be distortions where the acquisition occurs during one or both of the group's Base Periods and the groups have different year-ends prior to the acquisition. Another type of distortion could occur where the acquisition occurred after (or towards the end of) both group's Base Periods where one group had less than five years in its Base Period and the other group had a full five years.

Example I: Assume Parent-T Group had a four-year Base Period with distributions of zero for the first two years and $200 for the last two years and Parent-A Group had a full five year Base Period with distributions of $200 per year. But for the combination of the groups, Parent-T's Base Period Amount would have been $100 and Parent-A's Base Period Amount would have been $200. Once the Base Period Distributions are combined, the combined group's Base Period Amount would be $266 (not $300).

Nevertheless, we expect that the statute's use of the annual average and the elimination of the highest and lowest years would, in most cases, result in an appropriate Base Period Amount for the combined group. The election would also be available, if the acquisition occurs after Parent-A's Financial Statement End Date.

We considered whether a better solution would be to preserve the Parent-T Group as a shadow group within the Parent-A Group, applying Section 965 to the shadow group as if it were a separate consolidated group. Where one or both of the groups would have otherwise used the $500 million minimum, maintaining the Parent-T Group as a shadow-group would preserve both pre-combination thresholds. This would also prevent the excessively high or low Base Period Amount of either group from distorting the results for the other group. Nevertheless, we believe that maintaining a shadow group would be difficult to administer and inconsistent with the statutory scheme. Section 965(c)(5)

provides that corporations that are members of consolidated group during their Election Period are treated as one USSH for purposes of Section 965.[42] Creating two Section 965 taxpayers in this situation would be inconsistent with that rule.[43]

We believe that some additional advantages to allowing Parent-A to elect out become apparent when you consider our proposal for acquisitions during Parent-T Group's Election Period. As discussed above, Parent-T may elect to apply Section 965 to its last taxable year beginning before October 22, 2004, or its first taxable year beginning after that date. It is not clear from the statute if a taxpayer may elect to apply Section 965 to year in which it had no cash dividends eligible for the Section 965 election. As discussed in more detail in the following section, we are proposing that where Parent-T is acquired during (or after) Parent-T's Election Period, all of Parent-T's attributes stay behind (and be taken into account in the Parent-T Election Period). If there were no election-out of full inheritance for acquisitions prior to Parent-T's Election Period, we expect that some taxpayers might seek to make the Section 965 election for the Parent-T Group simply to wipe out its attributes. Take the following example:

Example J: Parent-T Group, a calendar year taxpayer, has a $100 Base Period Amount and no APB 23 Amount and is acquired during 2005, prior to filing its 2004 annual return. During 2004, Parent-T received cash dividends from its CFCs of $99. If Parent-T can elect to apply Section 965 to 2004, even though it did not receive any dividends eligible for the Section 965 dividends-received deduction, Parent-A would, under our proposal, not be required to inherit Parent-T's $100 Base Period Amount.

If the statute were read to permit the Parent-T Group to make the election only if it had dividends eligible for the Section 965 deduction, then the result for the Parent-A Group would be markedly different if, in Example J, Parent-T had received cash dividends from its CFCs during 2004 of $101, instead of $99. We do not believe that the results should differ so greatly on the basis of a single dollar of dividends.

Thus, the election-out avoids these anomalies and avoids having to determine if the statute permits an election to be made for a year in which the taxpayer has no qualifying dividends.

If Parent-A makes the no-inheritance election (or Parent-T makes a Section 965 election for a pre-acquisition period), no distributions from Parent-T's CFCs should be taken into account by Parent-A during its Election Year. Parent-A should not be able to

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[42] We have not addressed whether the result should be different where the Parent-T Group does not enter into the Parent-A Group's consolidated return.

[43] We do not believe, however, that it would be inconsistent with the statute to permit the acquiring group to "ignore" the target group where the acquisition occurred after the acquiror's Financial Statement End Date. We note that similar rules are provided in Treas. Regs. § 1.861-10.

utilize the unrepatriated earnings of Parent-T's CFCs unless it has inherited Parent-T's Base Period Amount.

We believe the election-out proposal is not susceptible to abuse. We also believe that it does not result in Base Period Distribution history being lost inappropriately, because of the companion requirement that no distributions from Parent-T Group's CFCs may be taken into account.

Another question that is raised is how, if at all, the rule in Section 956(c)(5)(B) should apply if Parent-T Group and Parent-A Group are not a single employer under Section 52(a) as of each of their Financial Statement End Dates, but they become a single employer at some time prior to Parent-T's Election Period, or, conversely, if they are a single employer as of their Financial Statement End Date but not during their Election Period. It is not clear if the rule in Section 956(c)(5)(B) (which requires all of the entities that constitute a single employer to share the $500 million minimum) applies only if the entities are a single employer during their Election Periods or whether it requires that the entities be a single employer as of their Financial Statement End Dates.[44]

The view that the single-employer test applies based upon the facts in existence during the Election Period, not on the Financial Statement End Date, would be supported by the fact that the single-employer rule does not refer back in time to the Financial Statement End Date and thus it seems to speak to the year in which the statute applies. In some cases this reading would benefit taxpayers and in other cases it would benefit the fisc.

Example K: Assume Parent-T Group and Parent-A Group are a single employer as of their Financial Statement End Dates, but prior to their Election Periods they cease to be a single employer. Prior to the separation, the two groups together were required to share the $500 million minimum; after the separation, each has its own $500 million.

Example L: Assume Parent-T Group and Parent-A Group are not a single employer as of their Financial Statement End Dates and each has an APB 23 Amount below $500 million, so each would have a separate $500 million amount. As of the first day of their Election Periods, they are a single employer and thus they must share a single $500 million minimum.

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[44] It would become even more complicated if the groups had different Financial Statement End Dates and they were a single employer as of one group's Financial Statement End Date, but not as to the others; or, if they had different Election Periods and they were a single employer during all or a portion of one group's Election Period, but not the others. We expect that these situations are unlikely to occur because the two groups would likely have the same accounting year and the same tax year and that both would make the election for their 2005 year.

We also note that our suggestions above regarding how to apply the $500 million minimum rule in the case where Parent-T is acquired by Parent-A prior to their Election Periods are consistent with the single-employer rule, since the combined groups would be a single employer during their post-acquisition Election Period.

An odd set of circumstances would exist if Parent-T is acquired prior to Parent-T's Election Period but after Parent-A's Election Period. Under our proposals there would be no opportunity for the post-acquisition group to claim Section 965 benefits based upon Parent-T's APB 23 Amount or based upon cash dividends from Parent-T's CFCs.

Example M: Assume Parent-A has a July 30 year-end and Parent-T has a September 30 year-end. Parent-A elects to apply Section 965 to its tax year ending July 30, 2005, and it acquires Parent-T on August 1, 2005. Parent-T did not elect to apply Section 965 to its year ending September 30, 2004, and had been intending to elect to apply it to its year beginning October 1, 2005.

This would, of course, be an unfortunate situation, but one that we believe is unlikely and that probably could be avoided (without disrupting the parties' business objectives) by delaying the acquisition until after Parent-T had made use of the benefits of Section 965.

C. Parent-T is Acquired During Parent-T's Election Period and Parent-T Makes a Section 965 Election

Proposed Rule:

1. General Rule – Parent T Group Ignored by Parent-A For All Section 965 Purposes:

Parent-A does not inherit any of Parent-T's Base Period Distribution history or APB 23 Amount, whether the transaction is taxable or tax-free to the shareholders of Parent-T, and no dividends paid by the CFCs that were in the Parent-T Group may be taken into account for Section 965 purposes by the Parent-A Group during its Election Period.

Discussion:

A taxpayer has an "Election Period" only if it affirmatively elects to have one when it files its tax return for the year.[45] An acquisition of Parent-T will cause the Parent-T Group's taxable year to close.[46] If Parent-T decides to make a Section 965

[45] See Section 965(f).

[46] Treas. Regs. § 1.1502-76(b)(2) (rule for when a group terminates). This assumes Parent-T and its consolidated subsidiaries will enter into the Parent-A consolidated return (continued . . .)

election for this short year, then all of its relevant Section 965 amounts should be taken into account in that short Section 965 year. To preserve the integrity of the statutory scheme, distributions from the Parent-T Group's CFCs should not be taken into account by Parent-A in computing its Election Period distributions. If this were not the case, those CFCs would be able to contribute to two different group's Section 965 deduction and we believe that would be clearly inappropriate.

If Parent-T does not *elect* any Election Period, then it has been acquired prior to its (non-existent) Election Period and the rule set forth in the preceding section should apply: Parent-A inherits Parent-T's Base Period and APB 23 Amounts, and distributions from Parent-T's CFCs during Parent-A's Election Period may be taken into account in applying Section 965 to Parent-A (subject to Parent-A electing out).[47]

We considered a rule under which, in the case of an acquisition during Parent-T's Election Period, all of Parent-T's attributes would be inherited by the Parent-A Group, including Parent-T's Election Period distributions and RPI amounts. Such a rule might be seen as appropriate where the Parent-T Group did not have enough time pre-acquisition to make full use of Section 965. Take the following example:

Example N: Parent-T intended its Election Period to be the 2005 calendar year. It has no Base Period Amount and an APB 23 Amount of 200. In January of 2005 it takes 100 of cash out of its CFCs as a dividend and then, before it has a chance to take out the additional 100, it becomes the target in a hostile takeover and is acquired by Parent-A. If Parent-T makes the Section 965 election for the preacquisition short-year, it is able to claim benefits for only 100, rather than 200, of dividends. If Parent-T does not make the election, its APB 23 Amount is inherited by Parent-A, but Parent-A gets no credit for the 100 it has already distributed.

(. . . continued)
group. If they do not, then there would be no need for any adjustments since the two groups would be separate USSHs for purposes of Section 965. (Parent-T and its consolidated subsidiaries might be prevented from entering into the Parent-A Group under the no re-consolidation for 60-months rule (Section 1504(a)(3)) or the rule limiting the consolidation of life insurance companies with non-life insurance companies (Treas. Regs. § 1.1502-44).) If they remain separate consolidated groups, but become a single employer, this could raise the issue we mentioned above with respect to how to apply the single-employer rule to transactions occurring after the Financial Statement End Date.

[47] Thus, Parent-T electing to apply Section 965 to a pre-acquisition period is essentially the same as Parent-A electing out of full-inheritance. In any case where the acquisition occurs after Parent-A's Financial Statement End Date and during a year when Parent-T could make the Section 965 election, the results would be the same whether it is Parent-T which elects into Section 965 or Parent-A which elects out of full-inheritance.

We are not recommending such a rule, however, because we think it would be inconsistent with the principles of separate taxable years and separate taxpayers. In addition, as noted above (with respect to an acquisition of Parent-T prior to its Election Period but after Parent-A's Election Period), we believe that taxpayers could plan around this situation (without much disruption to the business objectives of the acquisition).

Similarly, we considered whether the Parent-T Group should exist as a shadow-group within the Parent-A Group for the remainder of what would have been the Parent-T's Group's normal full-length taxable year. We think such a rule would also be inconsistent with the principle that an acquired group's taxable year closes when the group terminates as a result of an acquisition of the common parent.

D. USSH-T is Disposed of (or Spun-Off) Prior to Parent-T's Election Period

Proposed Rules:

1. General Rule – Apportionment Based Upon Post-Acquisition Ownership of the Parent-T Group's CFCs (or "Proportionate Inheritance"):

USSH-T takes with it the portion of the Parent-T Group's Base Period Distribution history and APB 23 Amount that is attributable to the CFCs owned by USSH-T immediately after the acquisition, whether the transaction is taxable or tax-free to the Parent-A Group. The remainder of the two amounts stay with the Parent-T Group.

2. Election-Out of Proportionate Inheritance:

If the acquisition occurs after Parent-A's Financial Statement End Date, Parent-A may elect, in lieu of applying Rule 1, to inherit none of Parent-T's Base Period Distribution history and APB 23 Amount, in which case, none of the cash dividends received from the CFCs that were in the Parent-T Group may be taken into account by Parent-A during its Election Period. The amounts are still eliminated from Parent-T's remaining amounts.

3. Special Rules Relating to APB 23 Amount Apportionment for Acquisitions Prior to Parent-A's Financial Statement End Date:

a. If the acquisition occurs prior to Parent-A's Financial Statement End Date (whether it is before or after Parent-T's Financial Statement End Date), Parent-A does not inherit any APB 23 Amount, but Parent-T does inherit its proportion of Parent-T's Base Period Amount.

b. If Rule 3.a applies, but the transaction occurs after Parent-T's Financial Statement End Date, Parent-T's APB 23 Amount is reduced by the amount which USSH-T otherwise would have taken with it.

4. Special Rules for Acquisitions after Parent-A's Financial Statement End Date:

a. If the transaction occurs prior to Parent-T's Financial Statement End Date and Parent-A does not elect out of proportionate inheritance, Parent-A either (a) inherits the APB 23 Amount shown on Parent-T's last pre-acquisition "applicable financial statement" with respect to the CFCs owned by USSH-T immediately after the

acquisition, or (b) computes an APB 23 Amount for those CFCs by averaging the APB 23 Amount shown on Parent-T's last pre-acquisition "applicable financial statement" and the APB 23 Amount shown on Parent-A's first post-acquisition "applicable financial statement" with respect to those CFCs.

b. If Parent-A had no APB 23 Amount or an ABP23 Amount of less than $500 million, such that it would have been using the $500 million, Parent-A may not add the inherited amount to its $500 million amount. Instead, it may aggregate the two amounts and if the sum exceeds $500 million, it may use that amount; if not, it is limited to $500 million.

c. If one of the groups had an earnings-permanently invested-abroad amount and the other had a deferred taxes amount, the deferred taxes amount would be converted to a permanently invested-abroad amount (in the manner provided by the statute) and then the appropriate two amounts would be combined.

5. Special Rule For Acquisitions After Parent-T's Financial Statement End Date:

If the disposition occurs after Parent-T's Financial Statement End Date and Parent-T would have been using the $500 million minimum, its $500 million minimum must be reduced by the amount allocated to USSH-T. The portion of the $500 million allocated to each of Parent-T's CFCs equals $500 million times the accumulated earnings and profits of the CFC as of the Financial Statement End Date divided by the accumulated earnings and profits of all of the CFCs included in the Financial Statements.

6. Application of Rules Where USSH-T is Spun-off:

Rules 1 and 5 apply. If the spin-off is prior to USSH-T's Financial Statement End Date but after Parent-T's Financial Statement End Date, Rule 3 a applies.

Discussion:

These rules (proportionate inheritance, election out if acquisition occurs after Parent-A's Financial Statement End Date, and special rules for computing and allocating the APB 23 Amount and $500 million minimum) mirror the rules we are proposing when the entire Parent-T Group is acquired prior to Parent-T's Election Period. The rules are essentially the same, except that here they are applied on a proportionate basis. We believe these proposals would further the statutory intent to the greatest extent because they would match up the Base Period Distribution history and APB 23 Amounts as closely as possible with the CFCs that contributed to those historic amounts and, presumably, could contribute in the Election Period to making distributions that equaled the Base Period Amount plus the APB 23 Amount. We also favor consistent rules for these two scenarios because we believe that, from Parent-A's perspective, an acquisition of a USSH holding a CFC should have the same results whether that USSH was the parent of a consolidated group or a member of the group.[48]

[48] Many of the anomalies and mis-match issues discussed in detail above under "Parent-T is Acquired by Parent-A Prior to Parent-T's Election Period…" are present here as well.

Rules 1 through 4.b are substantially identical to the rules for when Parent-T is acquired. Rule 5 above is needed to address a situation that would not occur when Parent-T is acquired. Rule 6. incorporates and broadens the rule in Section 965(c)(2)(C)(ii).

The following examples illustrate the rules we are proposing.

Example O: Parent-T Group owns CFC1 and CFC2, and its Base Period Amount is $100 million, based on $100 million in Distributions received from CFC2 in each of its Base Period years. CFC1 has an APB 23 Amount of $500 million. After Parent-T's Base Period and prior to its Election Period, Parent-T Group disposes of USSH that owns CFC2, or disposes of CFC2.

If Parent-T had retained CFC2 and taken its normal $100 million of distributions from CFC2, it could have repatriated an *additional* $500 million from CFC1 (or any other CFC) and claimed the Section 965 deduction for $500 million of the total distributions of $600 million. If USSH-T takes it Base Period history with it when it leaves the group (and Parent-T keeps CFC1's APB 23 Amount), Parent-T could claim a Section 965 deduction for $500 million without distributing the $100 million that it would have otherwise had to distribute. But, this result seems correct, because Parent-T no longer has CFC2.

On the acquiror's side of Example K, assume Parent-A has CFC3 with a $500 million APB 23 Amount and Parent-A's Base Period Amount (prior to the acquisition of USSH-T) is zero. If there is no increase to Parent-A's Base Period Amount, Parent-A in this example could obtain a Section 965 deduction for $100 million in distributions from CFC2 (which would not be extraordinary from CFC2's point of view).

Example P: Consider the same facts except that Parent-A acquires the USSH-T that owns CFC1 (and Parent-T retains CFC2). Now, Parent-T has CFC2, which had no APB 23 Amount (and has the $100 million million of current year earnings that Parent-T usually pulls out) and Parent-A has CFC1 with the $500 million APB 23 Amount earnings still in it. The statute's intent would be furthered to the greatest extent if Parent-A was incentivized to pull the APB 23 Amount out of CFC1 and Parent-T was not able to treat the $100 million from CFC2 as extraordinary. Under our proposal, Parent-A would have inherited the APB 23 Amount with respect to CFC1 and could therefore pull out the APB 23 Amount and claim a Section 965 credit with respect to that amount. Moreover, Parent-T's Base Period Distribution history would remain unchanged so it would have to continue its prior practice of having CFC2 distribute $100 million in order for other distributions to be eligible for the Section 965 deduction.

We believe that these examples illustrate that Base Period Distribution history and the APB 23 Amount attributable to a CFC should go with each USSH-T that leaves the group while it holds that CFC (but we do not believe that this example indicates that it should also go with CFC-T for the reasons discussed below under Section VI.F.).

One drawback of the rule that we propose is that Parent-A could be viewed as being harmed by the dividend paying history of the Parent-T Group. For example, if the Parent-T Group historically pulled all of its untaxed earnings out of the CFC that is owned by USSH-T (perhaps Parent-T had excess foreign tax credits from another source) and then it sells USSH-T to Parent-A, Parent-A will, under our proposal, inherit the entire Base Period Distribution history of the CFC owned by USSH-T. Although this may in some cases seem unfair to Parent-A, it seems to us to make more sense to have that history go with USSH-T (and its CFC). As discussed below, because of the effect of Section 1248, however, we do not believe that the history should go to the acquiror when the CFC itself is disposed of.

If the $500 million minimum is the relevant APB 23 Amount threshold for either Parent-T or Parent-A, apportionment becomes problematic. Our proposed Rules 4.b and 5 address this issue. We developed these proposals after considering the following fact patterns.

Example Q: Parent-T owns USSH-1 which owns CFC1 which has a $480 million APB 23 Amount. Parent-T also owns USSH-2 which owns CFC2 which has a $10 million APB 23 Amount. Parent-A acquires USSH-1. If USSH-1 took the $480 million with it (as we are proposing), the question that is raised is whether the Parent-T Group still be able to use the entire $500 million minimum. Under our proposal, the answer is no: the Parent-T Group would have to use a $20 million amount as its APB 23 Amount threshold.

If Parent-T were permitted to use the full $500 million in this case, and Parent-A had an APB 23 Amount in excess of $20 million prior to the acquisition, then the Extraordinary Transaction could increase the aggregate amount available to both groups – that is, Parent-T could still claim $500 million and Parent-A could increase its APB 23 Amount by USSH-1's $480 million.

If Parent-A had an APB 23 Amount of less than $20 million prior to the acquisition, it would be required to use the $500 million minimum even if it inherited all of USSH-1's $480 million. Thus, in that case, requiring Parent-T to reduce its $500 million by $480 million might seem inappropriate, since it would result in a decrease in the aggregate amount available to both groups. Allowing both groups the full $500 million minimum in such a case would, we believe, not be inconsistent with the statute, but it would be bad tax policy to have the results for Parent-T depend solely upon the APB 23 Amount situation of Parent-A, a separate and unrelated taxpayer.

If Parent-T had sold USSH-1 one day prior to Parent-T's Financial Statement End Date, it would have had an APB 23 amount on its Financial Statement of $10 million and would have been entitled to the full $500 million minimum. Although it might seem anomalous that the answer should be different simply because the sale of USSH-1 took place after the Financial Statement End Date, the statute creates that anomaly by using the Financial Statement End Date as the benchmark. We do not think that Treasury needs

to or should promulgate rules for Extraordinary Transactions that eliminate that anomaly for taxpayers who engaged in Extraordinary Transactions after the Financial Statement End Date.

Rule 5 addresses how to assign an APB 23 Amount to USSH-T when Parent-T has no APB 23 Amount on its Financial Statement. This proposed rule would apportion Parent-T's $500 million based upon the accumulated earnings in its CFCs as of the Financial Statement End Date. Of course, this is not a perfect answer, but we believe it is consistent with the policies behind the statute

Before settling on the rules set forth above, we considered several alternative ways of handling an acquisition of USSH-T. The other options we considered and the reasons we are not proposing these are as follows.

Alternative One: Base Period Amount and APB 23 Amount remain with the Parent-T Group as long as the Parent-T Group continues to exist as a separate group.

The rationale for this rule would be that Section 965 treats all the members of a consolidated group as a single taxpayer and that it would be consistent with that for the Base Period Amount and APB 23 Amount to remain with the consolidated group and not be allocated to any single member of the group. One advantage of such a rule would be the simplicity and clarity of its application – it would be entirely clear which corporations had the Base Period and APB 23 Amounts.

While some of our members favor such a rule for these reasons, overall we would not recommend such a rule. First, it would be inconsistent with the rule in Section 965(c)(5)(C)(i), which appears to require that Base Period Amounts be divided up when there has been a disposition; and, we believe that if the Base Period Amounts are to be divided up pursuant to that provision, the APB 23 Amounts should also be divided up, because both amounts are serving similar functions. We also believe that the same principles should be used to divide up the two amounts and that those principles should be that the amounts are allocated in a manner that correlates as closely as possible to the dividend-paying capacity of the CFCs.

Alternative Two: USSH-T takes with it the Base Period Distributions it actually received and the APB 23 Amount attributable to the CFCs it owned as of the Financial Statement End Date whether or not it owns these CFCs after the acquisition.

The rationale for this rule would be that the statute applies at the USSH-level and uses historic amounts, so the attributes should attach to the domestic corporation that owned the shares at the relevant historic times. One problem with this rule is that it does not match up the amounts to the CFCs with the dividend-paying capacity. We also believe that assigning the attributes in this way would not be as consistent with Section 41(f) principles as apportioning them in the manner we suggest (and which Section 965 uses for certain spin-offs).

The following two examples illustrate some of the problems with these two alternatives.

Example R: Parent-T Group owns USSH-T which owns CFC. Parent-T sells USSH-T to Parent-A, and Parent-T Group is left with no other CFCs. If Parent-T retains the Base Period and APB 23 Amount attributable to CFC, it cannot make any use of them. On the Parent-A side, if Parent-A is permitted to take into account distributions from CFC during Parent-A's Election Period but does not inherit any of the Parent-T Base Period attributable to CFC, than Parent-A has a Base Period Amount that is understated relative to the CFCs that it owns as of the Election Period.

Example S: At some time after Parent-T's Financial Statement End Date, USSH-T sells (or distributes) the shares in CFC to Parent-T and Parent-T then sells USSH-T to Parent-A. If USSH-T took the Base Period and APB 23 Amount attributable to CFC with it, this would distort the numbers for both the Parent-T and Parent-A Groups, since the CFC that generated those amounts has remained in the Parent-T Group.

We also considered whether there should be some reduction in the APB 23 Amount attributable to the CFCs owned by USSH-T if some or all of the APB 23 Amount had been distributed prior to the disposition of USSH-T. We decided that there should not be, because if there had been no Extraordinary Transaction, the APB 23 Amount of the Parent-T Group would not be adjusted for a distribution that occurred prior to the Election Period. In reaching this conclusion, we also considered the fact that a distribution can qualify for the Section 965 deduction even if the distribution is received from a CFC other than the one that had the APB 23 Amount. These issues are illustrated by the following example:

Example T: Parent-T Group owns CFC1 with no APB 23 Amount and CFC2 with an APB 23 Amount of $100. Prior to the disposition of USSH-T (which holds CFC2), CFC2 distributes the entire $100 to USSH-T. This could be during Parent-T's Base Period or after Parent-T's Base Period but prior to Parent-T's Election Period.

If Parent-T had not disposed of USSH-T (and, with it, CFC2), Parent-T could have taken a $100 distribution from CFC1 and claimed the Section 965 deduction for that distribution.

This example could lead one to believe that the APB 23 Amount should simply stay with the Parent-T Group if it has been distributed out prior to the acquisition, but we believe such a rule would be extremely complicated and inconsistent with the statutory scheme. Futhermore, if Parent-A acquires USSH-T when the deferred earnings are actually still in CFC2, then it would seem that the purposes of Section 965 would be better served if USSH-T took the APB 23 Amount with it.

Although we believe there is no perfect resolution to this issue, we believe that the statutory intent is best served if the APB 23 Amount goes with USSH-T, regardless of

whether the deferred earnings are, at the time of the acquisition, in fact still in the CFC owned by USSH-T.[49]

E. USSH-T is Acquired (or Spun-Off) During Parent-T's Election Period

Proposed Rules:

1. General Rule – USSH-T and its CFCs Are Ignored by Parent-A For All Section 965 Purposes:

Parent-A does not inherit any of Parent-T Group's Base Period Distribution history or APB 23 Amount, whether the transaction is taxable or tax-free to the shareholders of Parent-T, and no distributions made by the CFCs that are owned by USSH-T immediately after the acquisition may be taken into account by the Parent-A Group during its Election Period.

2. General Rule – Parent-T Must Retain All Attributes Attributable to USSH-T:

Parent-T may not eliminate the Base Period and APB 23 Amounts attributable to the CFCs owned by USSH-T.

Discussion:

Our proposed rule would treat an acquisition of USSH-T during Parent-T's Election Period in the same manner as an acquisition of Parent-T during its Election Period. As noted above in Section VI.C ("Parent-T is Acquired During Parent-T's Election Period and Parent-T Makes a Section 965 Election"), this may have results that seem unfair where the portion of the Election Period during which USSH-T is in the Parent-T Group is not long enough for USSH-T to bring up all the earnings from its CFCs that it otherwise would have.

Nevertheless, we believe that as a matter of tax policy, the best approach is to provide that any entity that was in a group during that group's Election Period may not participate in any other group's election period, even if the entity did not pay or receive dividends during the first group's Election Period. In other words, if an entity is in a group on the first day of that group's Election Period, the entity has had its Election Period, even if it enters another group before or during the acquiring group's Election Period. As discussed above, we believe this is fair to taxpayers and that taxpayers can

[49] If USSH-T is acquired with a Section 338(h)(10) election, such that Parent-T is treated as having sold all of the assets of USSH-T, then for purposes of these rules, we believe the transaction should be treated as a disposition of CFC-T, for the reasons set forth below addressing dispositions of CFC-T.

plan and time Extraordinary Transactions that take place during their Election Periods to prevent them from losing any otherwise available Section 965 benefits.[50]

The other alternatives we considered were:

Alternative One: USSH-T takes with it the Base Period and APB 23 Amounts that it would have taken if USSH-T were acquired prior to Parent-T's Election Period (i.e, the amounts that are attributable to the CFCs that it owns immediately after the acquisition), but the Base Period Amount and APB 23 Amounts are reduced by any distributions received by USSH-T from its CFCs prior to the acquisition (and taken into Parent-T Group's income) during Parent-T's Election Period. Any such reductions stay with the Parent-T Group. (This is essentially "remainder inheritance").

Alternative Two: Same as One, except that the APB 23 Amount is retained by Parent-T to the extent it has been distributed *at any time* after Parent-T's Financial Statement End Date and prior to the acquisition. (This is also a form of remainder inheritance, just with a different cut-off date.)

Alternative Three: Alternative One or Two, combined with an election-out of remainder inheritance for Parent-A.

Alternative One would give USSH-T and its CFCs the opportunity to take advantage of Section 965 during two separate short-years – the short year in the Parent-T Group and the short-year in the Parent-A Group. In certain cases, though, where USSH-T is acquired early on in Parent-T's Election Year, it may seem inappropriately harsh (and inconsistent with the statutory goals) not to allow USSH-T's Base Period Amount and APB 23 Amount to go with its cash-rich CFCs. We believe, however, that it would not be good policy to allow a CFC to contribute to two separate groups' Election Period dividends.

We also note that the amounts would not be lost, as they would stay in the Parent-T Group, they would just be separated from the CFCs to which they are attributable. Furthermore, as noted above in the case of an acquisition of Parent-T during its Election Period, the parties could structure and time the acquisition in order to permit Parent-T to pull the cash out of the CFC and the USSH-T (and back into members that will remain in the Parent-T Group) prior to the acquisition of USSH-T.

Alternative Two would make the adjustment in USSH-T's APB 23 Amount for any APB 23 Amount earnings that have been repatriated since Parent-T's Financial Statement End Date. In that case, Parent-T would keep the APB 23 Amount as long as

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[50] Where this proposed rule would hurt a taxpayer that has already engaged in a disposition during its Election Period, a private letter ruling issued to both Parent-T and Parent-A might be appropriate.

the earnings were not in the CFC at the time of the acquisition, and Parent-A would inherit only if the earnings were still in the CFC.

The rationale for remainder inheritance with respect to the APB 23 Amount is that if the Parent-T Group has pulled some or all of the earnings out of USSH-T's CFC prior to the disposition of USSH-T, then the Parent-T Group should keep the related APB 23 Amount; and conversely, where the earnings are still in that CFC at the time of the acquisition, the Parent-A Group should inherit the APB 23 Amount. This approach could be seen as best implementing Section 965's goal of encouraging the repatriation of APB 23 Amounts. Nevertheless, we favor our proposal for the reasons set forth above.

F. Parent-T Disposes Of (or Spins-Off) CFC-T At Any Time[51]

Proposed Rules:

1. Rules for Parent-T:

a. If disposition occurs prior to Parent-T's Financial Statement End Date, Parent-T eliminates the Base Period Amount attributable to CFC-T.

b. If disposition occurs after Parent-T's Financial Statement End Date but prior to Parent-T's Election Period, Parent-T may elect to either (i) retain both the Base Period Amount and APB 23 Amount attributable to CFC-T, or (ii) eliminate both amounts.

c. If the disposition occurs after Parent-T's Election Period has commenced, Parent-T must retain both the Base Period Amount and APB 23 Amount attributable to CFC-T.

2. Rules for Parent-A:

a. General Rule: Parent-A does not inherit any Base Period Amount or APB 23 Amount.

b. If acquisition occurs after Parent-A's Financial Statement End Date, Parent-A may not take into account any dividends from CFC-T for Section 965 purposes.

Discussion:

Under Rule 1.a, Parent-T would not own CFC-T during its Election Period and would have none of CFC-T's attributes for Section 965 purposes. We believe this is clearly the appropriate treatment for Parent-T where CFC-T was disposed of prior to Parent-T's Financial Statement End Date, which we view as the cut-off date that is most consistent with the statute.

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[51] For purposes of these rules, a disposition of USSH-T with a Section 338(h)(10) election such that USSH-T is treated as if it sold the shares in CFC (or a tiered Section 338 election such that both USSH-T and CFC are treated as having sold all of their assets) should be the treated the same as a disposition of the shares of CFC-T.

Under Rule 1.b, Parent-T would either have that same treatment or, at its election, could retain CFC-T's attributes even though it did not own CFC-T during its Election Period. The rationale for allowing Parent-T to retains the attributes in this case is twofold: first, for the reasons described below, Parent-A would not be inheriting CFC-T's attributes so this election would enable the attributes to be used by at least one of the groups; and second, the disposition occurred after Parent-T's Financial Statement End Date, which we view as an appropriate cut-off date to allow Parent-T to retain the attributes.[52] The election to eliminate would permit Parent-T to avoid being disadvantaged by having to retain a Base Period Amount for a CFC that it does not own during its Election Period, which we believe would not be appropriate.[53]

Rule 1.c is consistent with the principle that an entity that is in a group during its Election Period is in that group for Section 965 purposes. In this case Parent-T could bring out the APB 23 Amount through a pre-sale dividend which would be taken into account as a cash dividend under Section 965 (subject to some anamolies created by the subpart F ordering rules and Section 1248 which are discussed below).

The rationale for Rule 2.a is discussed in more detail below and is based primarily on the impact of Section 1248 on the earnings and profits CFC-T will have immediately after it it is acquired by Parent-A. If Parent-A acquires CFC-T after (or during) Parent-A's Base Period, perhaps Parent-A should be barred from using distributions from CFC-T for Section 965 purposes during its Election Period (because it may not have an appropriate Base Period Amount for CFC-T). We believe, however, that where the acquisition occurs prior to Parent-A's Financial Statement End Date, Parent-A should not be barred in this way even though Parent-A will not have a full five-year Base Period Distribution history for CFC-T.[54]

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[52] If the transfer of CFC-T occurs after Parent-T's Financial Statement End, but prior to Parent-A's Financial Statement End Date, Parent-T could retain the Base Period and APB 23 Amounts attributable to CFC-T *and* CFC-T could contribute to Parent-A's Election Period cash dividends (assuming CFC-T had undistributed earnings and profits during Parent-A's Election Period). Thus, this conflicts with the second principle set forth above in Section IV.B, but it furthers the goal of having no attributes lost and permits Parent-A to take into account during its Election Period all of the CFCs that it owned as of its Financial Statement End Date. If Parent-T and Parent-T had the same Financial Statement End Date, this situation would not arise.

[53] It would be particularly unfair to Parent-T if the disposition occurred after Parent-T's Financial Statement End Date but during its Base Period and the disposition was preceded by an abnormally large distribution by CFC-T.

[54] We recognize that this conflicts with the fifth principle set forth above in Section IV.B, but, as explained below, we believe that conflict is necessitated by Section 1248.

Under Rule 2.b, where the acquisition occurred after Parent-A's Financial Statement End Date, Parent-A would be so barred. This proposal is consistent with our prior proposals and our view of what is appropriate under the statute because it uses Parent-A's Financial Statement End Date as the cut-off point. We are proposing that any CFCs acquired by Parent-A after that point may not be used to pay dividends that are taken into account under Section 965 for Parent-A. We believe that barring Parent-A in the case of acquisitions after this cut-off point would be appropriate because the statute essentially uses that date as the date when the amount of Section 965 benefits became fixed. In this case, Parent-A would not have any Base Period Amount or APB 23 Amount with respect to CFC-T.[55]

While these proposed rules might seem to conflict with the views expressed in the preceding portions of this Report, they are driven by the impact of Section 1248 on the disposition of CFC-T and represent our attempt to reconcile the policies of Section 965 with the rules in the remainder of subpart F and Section 1248.

These proposals would appear to conflict with our general view that no amounts should be lost (or "disappear") as a result of an Extraordinary Transaction, because under these proposals, Base Period and APB 23 Amounts could disappear, depending upon when the transaction occurs. This disappearance could also be seen as conflicting with the statute's reference to the rules in Section 41(f)(3)(B) and (C), which transfer attributes from the seller to the purchaser but do not eliminate them.

Our proposals here would also appear to conflict with the rationale we articulated above in support of our inheritance rules where Parent-T or USSH-T is the target. The points made in the preceding portions of this Report would seem to support the view that where CFC-T is disposed of prior to Parent-T's Election Period, the Base Period and APB 23 Amounts attributable to CFC-T should be inherited by Parent-A because, theoretically at least, those amounts are a measure of the dividend-paying capacity of CFC-T during the Parent-A Election Period. In order words, the USSH which should have to satisfy the Base Period Amount threshold that CFC-T generated should be the USSH that owns CFC-T during that USSH's Election Period, and the USSH that should be incentivized to repatriate the earnings that were essentially "stuck" in CFC-T on Parent-T's Financial Statement End Date is the USSH that owns CFC-T during that USSH's Election Period.

Example U: Parent-T owns CFC-T which has distributed $100 in each Base Period year and has an APB 23 Amount of $200; Parent-T owns no other CFCs. Prior to Parent-T's Election Period, Parent-T sells USSH-T to Parent-A. It would not further the

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[55] In the unusual case where the acquisition occurs after Parent-A's Financial Statement End Date but during its Base Period and Parent-A received Base Period Distributions from CFC-T, it would be appropriate to permit Parent-A to exclude those Distributions in computing its Base Period Amount.

statute's intent for Parent-T to retain the Base Period and APB 23 Amounts. In this situation, Parent-T could not make use of the $200 APB 23 Amount. If Parent-A inherited both amounts, it could use CFC-T's current year earnings to satisfy the $100 Base Period Amount and, ideally would then be incentivized to pull out the $200 that corresponds to the $200 APB 23 Amount.

As this example illustrates, inheritance by Parent-A would appear to further the statutory intent to the greatest extent because it would appear to match up the dividend-paying capacity of CFC-T at the time it enters Parent-A's Group with the Base Period and APB 23 Amounts that it takes with it. But, once you consider the impact of Section 1248 on the disposition of CFC-T, that conclusion becomes less certain. As explained below, on account of Section 1248, we believe that, where CFC-T is acquired, there should be no APB 23 Amount inheritance, and, because we believe that Base Period Amounts and APB 23 Amounts should be treated consistently, we also believe there should be no Base Period Amount inheritance in that case.[56]

As indicated above, the effect of Section 1248 on the disposition of CFC-T has led us to propose rules for the disposition of CFC-T that appear to conflict with our other proposals and some of our goals and guiding principles. Arriving at proposed rules for the disposition and acquisition of CFC-T was complicated not only by Section 1248, but also by subpart F's Section 951 and 959 rules and the special rules in Section 965 relating to subpart F inclusions and Section 1248 amounts. We will focus first on the impact of Section 1248 on the treatment of Parent-A and why we are not proposing an inheritance rule where CFC-T is acquired.

Pursuant to Section 1248, the disposition of CFC-T by USSH-T generally will cause CFC-T's current and accumulated earnings and profits to be reduced by the amount

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[56] Another alternative would be to have Parent-A inherit the Base Period Amount but not the APB 23 Amount on the basis that without Base Period Amount inheritance Parent-A will inappropriately benefit from being able to make use of CFC-T's dividend paying capacity during its Election Period either to satisfy Parent-A's Base Period Amount or to claim the Section 965 deduction. A different formulation would be to allow Parent-A to elect either to inherit the Base Period Amount or to exclude all dividends paid by CFC-T from its Election Period distributions. This election-out could be made available to Parent-A only if it acquired CFC-T after Parent-A's Base Period had ended. A further refinement, where Parent-A had acquired CFC-T during Parent-A's Base Period, would be to require Parent-A to compute its Base Period Amount by including the average annual distributions received by Parent-A from CFC-T during the Base Period years when Parent-A held CFC-T (in other words, computing a Base Period Amount for CFC-T using a rule similar to that provided in Section 965(c)(2)(B)). In addition to these, there are likely many other ways you could try to replicate an appropriate Base Period Amount for CFC-T.

of USSH-T's gain.[57] In most cases, this will eliminate all or substantially all of CFC-T's accumulated earnings and profits. Thus, if the disposition occurs prior to Parent-A's Election Period (such that the remainder of CFC-T's acquisition year does not overlap with Parent-A's Election Period), the result of Section 1248 would be that all or most of CFC-T's pre-acquisition accumulated earnings and profits (i.e., theoretically those that correlated to its APB 23 Amount) would have been eliminated for U.S. tax purposes prior to Parent-A's Election Period.[58] In that case, a distribution to Parent-A during Parent-A's Election Period would be a "dividend" only to the extent of any of CFC-T's remaining historic earnings and profits (i.e., after application of Section 1248 to the disposition) plus any earnings and profits generated in the year or years following the acquisition year.

Thus, a distribution to the Parent-A Group during its Election Period of all or part of the cash which corresponded to the APB 23 Amount may not even constitute a taxable "dividend" to Parent-A (instead, it would be return of basis to Parent-A). If that is the case, Parent-A needs no Section 965 incentive to pull those earnings out, even if the cash that corresponded to the APB 23 Amount is still in CFC-T. Therefore, allowing Parent-A in that case to inherit the APB 23 Amount will give Parent-A an overstated APB 23 Amount.

Example V: Parent-T owns CFC-T with an APB 23 Amount of $100 and current and accumulated earnings of $100. Parent-T has a basis of zero in the shares of CFC-T. After Parent-T's Financial Statement End Date and prior to Parent-A's Election Period, Parent-T sells CFC-T to Parent-A for $150. For simplicity, assume the sale occurred on the last day of CFC-T's taxable year. Under Section 1248, $100 of Parent-T's $150 of gain is treated as a dividend and CFC-T's earnings and profits are reduced to zero. CFC-T enters the Parent-A Group with no accumulated earnings and profits; Parent-A has a basis in the shares of CFC-T of $150. During Parent-A's Election Period, CFC-T

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[57] Technically, the amount of earnings and profits that is eliminated is capped at the earnings and profits attributable (under the rules in Treas. Regs. §§1.1248-2 or -3, whichever applies) to the shares of CFC-T owned by USSH-T. In addition, the effect of Section 1248 on current earnings will depend upon the amount of pre- and post-sale actual distributions made by CFC-T as well as post-sale earnings. Earnings and profits of CFC-T that correlate to PTI will also be reduced, even though USSH-T's gain will not include that PTI (by operation of the rule in Section 962(a) which increases a USSH's basis in CFC stock by subpart F inclusions).

[58] Under Section 1248, the disposition could also reduce CFC-T's current year's earnings and profits. If CFC-T remains a CFC after the acquisition, any current earnings and profits would be allocated first to any subpart F inclusions for the year (which would be picked up by Parent-A, as the shareholder on the last day of the year) or actual dividends paid to the Parent-A Group by CFC-T in that same year (current earnings and profits are allocated to actual distributions prior to being allocated pursuant to Section 1248).

distributes $100 to Parent-A. CFC-T has not generated any earnings since the acquisition. The entire $100 is a non-taxable return of basis to Parent-A.

This example illustrates the reasoning behind proposed Rules 2.a and b. It seems to us that the statute's intent would be best served by allowing Parent-A to take into account Election Period dividends from CFC-T only if Parent-A owned CFC-T on Parent-A's Financial Statement End Date. In that case, Parent-A would have an APB 23 Amount for CFC-T that would, presumably, match up to the earnings and profits in CFC-T (as computed under U.S. tax principles) which would otherwise be subject to U.S. tax in the hands of Parent-A if repatriated. Any APB 23 Amount that Parent-T had for CFC-T would not match up to the post-acquisition situation – i.e., the U.S. tax cost of pulling cash out of CFC-T which led to Parent-T's APB 23 designation would not match the U.S. tax cost to Parent-A of pulling out that cash.[59]

Determining what policies should guide the treatment of Parent-T when it disposes of CFC-T is complicated by the rules in Section 965 with respect to distributions of PTI (amounts excluded from income under Section 959) and Section 1248 amounts, and by the subpart F ordering rules.

First, Section 956 provides that Section 1248 inclusions are not treated as dividends, either for purposes of computing the USSH's Base Period Amount or Election Period cash dividends.[60] Second, distributions of PTI are included in Base Period Distributions, but are not included in Election Period cash dividends.[61] Third, under subpart F, inclusions of subpart F income are taken into account by a USSH prior to actual distributions; and actual distributions, even if in the same year as a subpart F inclusion, are treated as distributions of PTI and not as dividends.

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[59] Different questions are raised for Parent-A where the acquired CFC was not a "controlled foreign corporation" prior to the acquisition. In that case, arguably principles similar to those in Section 41(f)(3)(A) *could* apply with respect to Base Period Distributions but, depending upon the tax status of the seller of the foreign corporation, those Base Period Distributions may not be a fair benchmark to require Parent-A to inherit. The earnings and profits of the foreign corporation would not have been eliminated by operation of Section 1248, but they may not have been eliminated by a Section 338(g) election made by Parent-A. Thus, designing rules for the determination of an appropriate Base Period Distribution history and APB 23 Amount for such a CFC would be difficult, at best. Nevertheless, if the CFC is acquired prior to Parent-A's Financial Statement End Date, it would seem inappropriate to us to bar Parent-A from taking cash dividends from that CFC into account during Parent-A's Election Period.

[60] Sections 965(b)(3)(B) and (c)(3).

[61] Section 965(b)(2)(B)(iii).

We try to illustrate below how the combination of these rules creates results that we found anomalous and problematic, both as a matter of tax policy in general and in terms of determining the appropriate treatment of Parent-T.

If the USSH has a subpart F inclusion and receive an actual distribution of that amount during the USSH's Base Period, that distribution is included in the USSH's Base Period Distributions, whereas if the subpart F inclusion and distribution occur during the Election Period, the distribution is not included in Election Period cash dividends.

Example W: In each Base Period year, CFC-T had subpart F income of 100, which it distributed to Parent-T. During the Election Period, CFC-T had subpart F income of 100, which it distributed to Parent-T, but this may not be taken into account to satisfy the 100 Base Period Amount attributable to CFC-T.

If a USSH sells a CFC during its Base Period and while the CFC has earnings and profits that would be PTI if distributed, the USSH's gain on the sale will be reduced by the amount of PTI (by virtue of the rule in Section 961(a) that increases the USSH's basis in the CFC shares by subpart F inclusions). If the USSH had instead drawn cash out of the CFC prior to the sale, the distribution of the PTI would have been included in the USSH's Base Period Amount.

If that same disposition of the CFC instead occurred during Parent-T's Election Period, the pre-sale distribution of PTI would not be included in the Election Period cash dividends.

If, on the other hand, CFC-T had no PTI, a pre-sale distribution to Parent-T would be taken into account as dividend (whether during the Base Period or the Election Period). If the sale is not preceded by an actual distribution, the Section 1248 inclusion of those earnings and profits would not be taken into account, either as a Base Period Distribution or an Election Period cash dividend.

To add another twist to the analysis, if the disposition of CFC-T by Parent-T causes CFC to cease to be a CFC, then any subpart F income for the year would be taken into account by Parent-T prior to the sale, as subpart F income. In such a case, any pre-sale distribution by CFC-T to Parent-T would be treated as PTI, and thus counted in Base Period Distributions, but not Election Period cash dividends.

To further complicate matters, if CFC-T is acquired by Parent-A and CFC-T remains a CFC, any subpart F income for the year is allocated to Parent-A (and, any actual distribution of those earnings would be PTI to Parent-A). In addition, any post-acquisition distributions to Parent-A in that same year that are not PTI will be allocated CFC-T's current earnings and profits, prior to their being allocated to Parent-T under Section 1248.

Another example would be the difference in the treatment of a disposition of CFC-T where there is a Section 338 election made by Parent-T. If the disposition gives

rise to subpart F income, any pre-sale distribution would be PTI and thus included in the Base Period Amount if the sale occurs during the Base Period, but not included in Election Period cash dividends if the sale occurs during the Election Period.[62]

As illustrated above, these anomalies arise primarily where there has been an Extraordinary Transaction, but not exclusively.[63] After considering all of these fact patterns, we found it particularly difficult to determine what proposed rules for an Extraordinary Transaction involving CFC-T would be most consistent with Section 965 and the statutory intent. We believe that there is no correct solution to the problems that are raised where CFC-T is disposed of/acquired and we believe that any set of rules will arrive at what appears to be an appropriate result in some cases and an inappropriate result in others. In some cases, it may not even be clear what result would be appropriate.

We focused, however, in particular on the fact that a Section 1248 amount is not taken into account as a Section 965 cash dividend means that a USSH that is selling a CFC-T during Parent T's Election Period will have markedly different tax results if it structures the sale so that it is preceded by an actual withdrawal (in the form of cash) of the CFC's current and accumulated earnings and profits (or even just a portion of those earnings and profits).[64]

Take the following examples:

Example X: Parent-T Group has an APB 23 Amount of $100 with respect to CFC-T. For U.S. Federal income tax purposes, CFC-T has $100 of undistributed earnings and profits. Parent-A is willing to purchase CFC-T (during Parent-T's Election Period) for $150 or for $50 if the $100 is removed prior to the purchase. Parent-T has a basis of zero in the stock of CFC-T and sells CFC-T during Parent-T's Election Period.

(a) If CFC-T distributes the $100 to Parent-T and is then sold for $50 (and Parent-T has otherwise satisfied its Base Period Amount threshold), Parent-T pays tax on $100 at the reduced rate of 5.25% and on $50 at the normal 35% (or

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62 Depending upon the facts, other anomalies could result from the fact that the aggregate earnings and profits attributable to the outstanding shares under Treas. Regs. § 1.1248-3 may exceed the earnings and profits available for distribution as a "dividend". This could occur, for example, where there has been more than one USSH in the CFC and the dividends paid to one USSH were paid out of earnings and profits that are "attributable" to the other USSH's shares under Treas. Regs. § 1.1248-3.

63 We expect that, given the seemingly infinite number of fact patterns that there are, there are many other anomalies and incongruous results from the intersection of the subpart F ordering rules, Section 1248 and Section 965.

64 We note that this Section 1248 problem may also be present where USSH-T transfers a CFC to another group member prior to USSH-T leaving the group.

15%) rate (assuming no post-acquisition distributions to Parent-A in CFC-T's same year).

(b) If CFC-T does not distribute the $100 pre-sale, Parent-T pays tax on $150 at 35% (or 15%).

(c) If CFC-T distributes $100 to Parent-T pre-sale and another $100 to Parent-A post-sale, but in the same CFC-T tax year, Parent-A has a $100 cash dividend that is eligible for Section 965 treatment (unless future guidance provides that distributions from CFCs acquired by Parent-A under these facts could not be taken into account under Section 965) and Parent-T pays tax at the 35% (or 15%) rate on the entire $150 of gain.

(d) The same result occurs for Parent-A if CFC-T does not make any pre-sale distribution but makes a post-sale distribution of $100 to Parent-A (subject again to administrative guidance providing otherwise).

(e) If the facts are the same as in (c), but the distribution to Parent-A occurs after the close of CFC-T's acquisition tax year, the result for Parent-T is the same as in (a) above; and the result to Parent-A depends upon the post-acquisition year earnings and profits of CFC-T.

The fact that a sale during Parent-T's Election Period could have such drastically different tax results to Parent-T based upon (1) whether Parent-T takes a pre-sale distribution and (2) whether Parent-A takes a post-acquisition distribution, and exactly when Parent-A takes that distribution, is troubling, but it is a result of the way the statute is drafted.

This is, of course, in part the same problem that was created by the Section 246 dividends-received-deduction and that led to the *Waterman Steamship* line of cases.[65] Those cases considered whether the pre-sale distributions should be recharacterized as part of the purchase price, and focused on whether the pre-sale dividends were, in substance, funded by the purchaser. The imposition of foreign dividend withholding taxes may constrain pre-sale cash distributions from CFC-T to some extent, but if the USSH obtains a full foreign tax credit for the withholding taxes (after applying Section 901(k)) there may be no disincentive to such self-help other than concern that the transactions will be recharacterized under the *Waterman Steamship* line of cases. We read those cases as requiring a very tight series of links between the pre-sale borrowings and distributions by the CFC and post-sale repayment of the borrowings out of funds provided by the acquiror before a pre-sale distribution will be recharacterized as purchase price. We believe that any recharacterization in the Section 965 context should likewise be limited, particularly in light of the policies behind Section 1248 and Section 965 and the impact of the subpart F rules. We note that if the CFC had not been sold, its USSH

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[65] In some ways the disparate treatment of the two transactions seems particularly inappropriate where the target is a CFC since Section 1248 recharacterizes the seller's gain as a dividend to the extent of the earnings and profits attributable to the shares being sold.

could have claimed Section 965 benefits for Election Period distributions paid by the CFC from borrowings from an unrelated person (even a U.S. bank).

We attempted to fashion a proposal that would result in no attributes being lost, but we could not come up with any proposal that we believed was workable and fair to both groups.[66]

One alternative we considered was recomputing the APB 23 Amount with respect to CFC-T immediately prior to the acquisition. If the APB 23 Amount earnings were still in CFC-T, then CFC-T would take the APB 23 Amount with it. To the extent that earnings equivalent to the APB 23 Amount had been pulled out, Parent-T would keep that amount. Such a rule would seem to further the statutory intent because the APB 23 Amount would go with CFC-T only to the extent the earnings were still in the CFC-T when it was acquired.

One oddity of this rule would that be that a distribution of CFC-T's earnings to the Parent-T Group prior to the acquisition would cause the APB 23 Amount to remain in the Parent-T Group. Thus, the Section 965 impact of the transaction to both groups would differ markedly depending upon whether Parent-T pulled out the earnings prior to the sale and received less purchase price, or left the earnings in CFC-T and received more purchase price. This seems inconsistent with the rule in Section 965 that provides that amounts taken into income under Section 1248 are not treated as dividends for either the Base Period or the Election Period.

Another alternative we considered was recomputing the APB 23 Amount as of the first day of Parent-A's Election Period. This rule would allocate the APB 23 Amount to Parent-A only to the extent the cash was still in CFC-T at the time when Section 965 could incentivize Parent-A to pull the earnings out. While this would seem to best further the statutory intent, we believe it could lead to inappropriate results if the earnings and profits of CFC-T had been eliminated or reduced by operation of Section 1248.

This approach would also be inappropriate as a policy matter, we believe, because Parent-T would lose the APB 23 Amount unless it had caused the earnings to be distributed prior to the acquisition or Parent-A Group had caused the earnings to be distributed *after* the acquisition (but prior to the Parent-A's Election Period). The former

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[66] One idea we considered was if the acquisition occurred prior to Parent-A's Financial Statement End Date, it would inherit the Base Period Amount and Parent-T would be required to eliminate the Base Period Amount and any APB 23 Amount attributable to CFC-T; whereas, if the acquisition occurred after Parent-A's Financial Statement End Date, Parent-T would retain both amounts. It seems to us somewhat inappropriate for the results to Parent-T to depend upon whether the acquisition was before or after Parent-A's Financial Statement End Date since they are two separate taxpayers.

would create a windfall to Parent-A (because it would get the APB 23 Amount even though it was purchasing a CFC that had no permanently reinvested amounts in it) and the latter would seem unfair to Parent-T.

A variation on this would be to recompute the APB 23 Amount immediately after the acquisition. Another problem with both of these ideas is that it is not at all clear how such a recomputation could be done (given the accounting rules for designating an APB 23 Amount), unless Parent-A had an applicable financial statement that reflected CFC-T after the acquisition and prior to its Election Period.

Of course, in any particular factual situation, which of the two groups would benefit and which of the two would be hurt by having the Base Period and APB 23 Amounts attributable to CFC-T would differ, depending upon what the two amounts were. Similarly, if the allocation of the attributes were driven by which result would cause more cash to be brought back to the United States, there would be no single answer that would bring about that result in all cases.

We also considered whether, as a policy matter, the disposition/acquisition of CFC-T should be treated exactly the same as the disposition/acquisition of a USSH-T which owns CFC-T immediately after the disposition/acquisition. Where USSH-T is the acquired entity, we are proposing that it take the portion of Parent-T Group's Base Period and APB 23 Amounts attributable to the CFC's held by USSH-T immediately after the acquisition, unless the acquisition occurs during (or after) Parent-T's Election Period. Although we believe that the two transactions should as a policy matter be treated the same, the difference in the U.S. Federal income tax results of the two transactions has led us to propose different rules for the two scenarios.[67]

VII. Related Party Indebtedness

A. Introductory Discussion

The statute compares the amount of RPI of all the USSH's CFCs as of last day of the Election Period to the amount of RPI as of October 3, 2004. To the extent the amount of RPI has increased, the cash dividends received from CFCs during the Election Period that may be taken into account under Section 965 are reduced.

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[67] As noted in Part VIII. below, we believe that Treasury's guidance should include a statement that step-transaction and other substance-over-form principles will be applied in determining the effect of an Extraordinary Transaction on the Section 965 computations. Nevertheless, we believe those principles should not be applied only where the form of the transaction is clearly not in accordance with the substance and the result is inconsistent with the intent of Section 965.

The purpose of this requirement is to prevent the distributions received by the USSH from being made out of the that were already in the United States – or, to put it another way, to insure that the statute causes the repatriation of funds that were located outside of the United States on October 3, 2004.[68] Thus, indebtedness of one CFC to a related CFC is ignored.

The question here is whether, and if so how, the RPI of the Parent-T Group or the Parent-A Group as of October 3, 2004, should be adjusted where there is an Extraordinary Transaction during the period from October 4, 2004, through the last day of that group's Election Period. (We note that the last day of the Parent-T Group's Election Period may not be the same as the last day of the Parent-A Group's Election Period.) The question arises only if a CFC-T with RPI (or a USSH-T that owns a CFC with RPI) is disposed of by Parent-T after October 3, 2004, and prior to last day of Parent-T's Election Period, or if Parent-A acquires a CFC-T or a USSH-T that owns a CFC, where the CFC has that RPI immediately after the acquisition and the acquisition occurs after October 3, 2004, and prior to the last day of Parent-A's Election Period.

If Parent-A has disposed of USSH-T in a transaction where USSH-T becomes a standalone corporation (or the parent of a new consolidated group), there is also a question as to what USSH-T's October 3, 2004 RPI should be. Under our proposed rule described above, USSH-T would not be permitted to claim any Section 965 benefits if it was in the Parent-T Group during Parent-T's Election Period. Accordingly, under our proposed rules, the issue arises for USSH-T only if it is disposed of after October 3, 2004, and prior to the first day of Parent-T's Election Period.

In considering these questions, we took into account the fact that an Extraordinary Transaction might cause indebtedness of a CFC to be converted from RPI prior to the Extraordinary Transaction to non-RPI indebtedness after the Extraordinary Transaction. Thus, the amount of the CFC's RPI could decrease without any actual change in its total indebtedness. Accordingly, if a CFC simply took its October 3, 2004 RPI with it when it left the Parent-T Group, it would have an over-stated October 3, 2004 number, thereby potentially creating a cushion for the creation of RPI without that additional RPI having any impact under Section 965.

We also took into account that RPI which would otherwise become non-RPI after an Extraordinary Transaction would in almost every case be repaid or eliminated prior to or as part of the Extraordinary Transaction.

Take the following examples:

Example Y: On October 3, 2004, Parent-T Group owned CFC1 with $100 of RPI owed to Parent-T, and CFC2 with no RPI. Some time after that date, CFC1 leaves the

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[68] *See* Conference Committee Report, H.R. Conf. Rep. No. 108-766 (at. Ftn. 109).

Parent-T Group and the indebtedness remains in existence or is repaid. On the last day of Parent-T's Election Period, its RPI would have been decreased by $100, creating an opportunity for the Parent-T Group to fund Section 965 distributions with RPI from Parent-T to CFC2. Parent-A is unaffected, by the indebtedness of CFC1 (if it remains in existence) because it is no longer RPI.

Example Z: The same facts as the prior example except CFC1's debt is owed to USSH-T and USSH-T is acquired (while it still owns CFC1). Now, Parent-T Group is again given $100 of cushion, but Parent-A Group is saddled with an increase of $100 in RPI even though it has not made any new loans to its CFCs.

B. Recommendations

Proposed Rules:

1. Rules for Parent-T:

a. Where Parent-T disposes of USSH-T (that owns CFC-T) or of CFC-T prior to Parent-T's Election Period, Parent-T eliminates CFC-T's RPI from its October 3, 2004 RPI.

b. Where Parent-T disposes of USSH-T (that owns CFC-T) or of CFC-T during Parent-T's Election Period, Parent-T may elect to either (i) eliminate CFC-T's RPI from its October 3, 2004 RPI and not take into account any dividends received from CFC-T for Section 965 purposes, or (ii) add to its Election Period end date RPI, the RPI of CFC-T immediately prior to the disposition (in which case it may take into account any Election Period dividends received from CFC-T).

2. Rule for Parent-A If Parent-A Group Acquires Parent-T Group Prior to Parent-T's Election Period:

Parent-A inherits Parent-T Group's October 3, 2004 RPI.

3. Rules for Parent-A if Parent-A Group Acquires USSH-T (owning a CFC)

a. If Parent-A is inheriting the Base Period and APB 23 Amounts attributable to the CFCs owned by USSH-T, Parent-A must add to its October 3, 2004, the RPI the RPI of those CFCs immediately after the acquisition.

b. If Parent-A is not inheriting the Base Period and APB 23 Amounts attributable to the CFCs owned by USSH-T, Parent-A excludes those CFCs' RPI from Parent-A's Election Period end date RPI (and, as provided for in the prior rules, may not take into account any dividends received from CFC for Section 965 purposes).

4. Rule for Parent-A if Parent-A Group Acquires CFC-T:

No adjustment is made to Parent-A's October 3, 2004 RPI.

5. Rules for USSH-T Which Becomes a Standalone Corporation or The Parent of A New Consolidated Group:

a. If USSH-T is taking with it the Base Period and APB 23 Amounts attributable to the CFCs owned by USSH-T, USSH-T must create a start-date RPI equal to the RPI of those CFCs immediately after the acquisition.

b. If USSH-T is not taking with it the Base Period and APB 23 Amounts attributable to the CFCs owned by USSH-T, USSH-T's RPI would not matter because, as provided for in the prior rules, USSH-T would have already participated in Parent-T's Election Period.

Discussion:

Under our proposed Rule 1.a, where the disposition occurs after October 3, 2004, but prior to Parent-T's Election Period, Parent-T simply eliminates the CFC's RPI from its October 3, 2004 RPI. This is appropriate because Parent-T will have no Election Period dividends from the CFC that is disposed of.

Under Rule 1.b., Parent-T has a choice of either ignoring the CFC for all purposes, or creating an end-date RPI equal to the RPI of the CFC immediately prior to the disposition. We believe this would achieve the statutory intent.

For Parent-A, the RPI question arises only for acquisitions after October 3, 2004 and prior to the last day of Parent-A's Election Period. Our proposed rules for RPI follow our proposed rules for the treatment of Base Period Distributions and APB 23 Amounts. Generally, where there is Base Period Distribution and APB 23 Amount inheritance, there is RPI recomputation, and where there is no Base Period Distribution or APB 23 Amount inheritance, recomputation is unnecessary because the acquired entities are not participating in Parent-A's Election Period dividends.

Under our proposed Rule 2, Parent-A inherits Parent-T Group's October 3, 2004 RPI rather than recomputing the RPI as of immediately after the acquisition. This may appear to conflict with our statement above that from Parent-A's perspective, the acquisition of a USSH should be treated the same whether that USSH is the parent of a consolidated group or a member of that group. We believe that recomputation where the entire group is acquired would be inappropriate and susceptible to manipulation because the Parent-T Group could simply create new RPI after October 3, 2004, but prior to the acquisition. In that case, a recomputation would enable the two groups to increase their aggregate RPI without it causing any reduction in their Section 965 dividends, in clear contravention of the statutory intent.

Under our proposed Rules 3.a and b, where Parent-A acquires USSH-T (owning CFCs), the result is driven by whether USSH-T was in the Parent-T Group during that group's Election Period. If USSH-T has been in the Parent-T Group during Parent-T's Election Period, there is no issue for Parent-A because Parent-A is barred from taking dividends from USSH-T's CFCs into account under Section 965. If the acquisition is prior to Parent-T's Election Period, Parent-A creates a beginning-date RPI equal to the RPI of USSH-T's CFCs immediately after the acquisition. Again, we believe this would achieve the statutory intent.

Rules 5.a and b are the same as Rules 3.a and b, adjusted to take into account that USSH-T is creating a new consolidated group immediately after the acquisition, rather than entering a group that was in existence on October 3, 2004.

VIII. Additional Recommendations Relating to Upcoming Guidance

We recommend that the regulatory guidance provide that the step-transaction and other substance-over-form principles will apply in determining the effect of an Extraordinary Transaction on the Section 965 computations.

We also believe it would be ideal if the guidance could provide for an expedited private letter ruling process in the case of taxpayers who believe their situations are not addressed by the rules set forth in the guidance or that those rules lead to inappropriate results.

The guidance should provide for some mandatory sharing of information between Parent-T and Parent-A where there is inheritance, so that amounts are not lost. It seems appropriate for this information sharing to follow the model in the regulations under Section 41(f)(3)(B).

IX. Certain Additional Issues That We Have Not Addressed

In addition to various issues noted above, some additional issues that we have not fully addressed are as follows.

1. Section 965(c)(2)(B) provides that if the USSH has fewer than 5 taxable years ending on or before June 30, 2003, than all such years are included in the taxpayer's base period. If the acquiring corporation has a Base Period of less than 5 years under this rule, but acquires a target that has a full five year Base Period and the acquiror inherits the target's Base Period history, should the acquiror computes its Base Period threshold as if it had five full years or should the less-than-five year rule apply such that the only years of the target that are taken into account are the years that the acquiror would have otherwise taken into account?

2. What should be done if the target and the acquiror have different taxable years and the acquisition occurs during a Base Period year?

3. What should be done if the acquiror's or the target's Base Period includes any short-years? Section 41(f)(4) provides that in the case of short taxable years, R&D expenditures and gross receipts be annualized. We note that Section 965 refers to Sections 41(f)(3)(A) and (B) and does not refer to Section 41(f)(4). Annualization in the event of a short year could result in an inappropriately high or low number since distributions may be increased or reduced on account of the event that caused there to be a short year.

4. Questions with respect to the special spin-off rule in Section 965(c)(2)(C)(ii):

a. Controlled will have two short years during the taxable year of the spin-off so that its five year Base Period will not include the first year that is included in Distributing's Base Period. Seems not to be how it was intended to work.

b. Under the rule, Base Period Distributions from any particular CFC is not allocated between the two if neither is a USSH in the CFC immediately after the spin. Does that mean that, in that case, the Base Period Distribution history remains with Distributing's continuing consolidated group? The fact that the lead-in language in (ii) states that rule applies only if Controlled is a USSH suggests that the flush language at the end would apply only if the Controlled is a USSH and the Distributing is not. Presumably in that case the intent would be that the Base Period Distribution history goes with Controlled.

c. Is allocation based upon vote or value? Stature refers to "interests as USSHs". Because the USSH test (in Section 951(c)) is a vote test, does this mean in proportion to voting interests held in the CFC, or should it be value because that would seem to correlate more closely to their respective interests in the CFC's earnings and profits post-spin?

Appendix – Summary of Proposed Rules

I. Adjustments to Base Period Amount and APB 23 Amount

A. Parent-T is Acquired by Parent-A Prior to Parent-T's Election Period or Parent-T Makes No Section 965 Election

Proposed Rules:

1. General Rule – Full Inheritance:

Parent-A inherits Parent-T's Base Period Distribution history and APB 23 Amount (if any), adding Parent-T's amounts to Parent-A's amounts, whether the transaction is taxable or tax-free to the shareholders of Parent-T.

2. Election-Out of Full Inheritance:

If the acquisition occurs after Parent-A's Financial Statement End Date,[69] Parent-A may elect, in lieu of applying Rule 1., to inherit none of Parent-T's Base Period Distribution history and APB 23 Amount, in which case, none of the cash dividends received from the CFCs that were in the Parent-T Group may be taken into account by Parent-A during its Election Period.

3. Special Rule Relating to APB 23 Amount Inheritance for Acquisitions Prior to Parent-A's Financial Statement End Date:

If the acquisition occurs prior to Parent-A's Financial Statement End Date (whether it is before or after Parent-T's Financial Statement End Date), Parent-A does not inherit any APB 23 Amount, but does inherit Parent-T's Base Period Amount. Parent-A may not, in this case, elect-out of inheriting Parent-T's Base Period Amount (because the acquisition by Parent-A occurred prior to Parent-A's Financial Statement End Date).

4. Special Rule for Acquisitions After Parent-A's Financial Statement End Date but Prior To Parent-T's Financial Statement End Date:

If Parent-A does not elect out of full-inheritance (under Rule 2 above), it either (a) inherits the APB 23 Amount shown on Parent-T's last pre-acquisition "applicable financial statement", or (b) computes an APB 23 Amount for the Parent-T Group's CFCs by averaging the APB 23 Amount shown on Parent-T's last pre-acquisition "applicable financial statement" and the APB 23 Amount shown on Parent-A's first post-acquisition "applicable financial statement" with respect to the Parent-T Group's CFCs.

5. Special Rules for Acquisitions Occurring After Both Groups' Financial Statement End Dates:

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[69] As mentioned above, an alternative cut-off date after which the election-out could be available would be the last day of Parent-A's Base Period. We believe, however, that the Financial Statement End Date is a more appropriate cut-off date.

a. If one of the groups had an earnings-permanently invested-abroad amount and the other had a deferred taxes amount, the deferred taxes amount would be converted to a permanently invested-abroad amount (in the manner provided by the statute) and then the two amounts would be combined.

b. If one of the groups had an APB 23 Amount and the other had none, such that the minimum $500 million was the relevant amount for the latter group, Parent-A would be required to choose either the APB 23 Amount or the $500 million minimum. It could not combine the two.

c. If both groups had an APB 23 Amount of less than $500 million and would therefore both have used the $500 million minimum amount, the Parent-A Group may not combine the two $500 million amounts, although it may combine the two APB 23 Amounts. If the combined APB 23 Amount is greater than $500 million, the Parent-A Group may use that aggregate amount.

B. Parent-T is Acquired During Parent-T's Election Period

Proposed Rule:

1. General Rule – Parent T Group Ignored by Parent-A For All Section 965 Purposes:

Parent-A does not inherit any of Parent-T's Base Period Distribution history or APB 23 Amount, whether the transaction is taxable or tax-free to the shareholders of Parent-T, and no dividends paid by the CFCs that were in the Parent-T Group may be taken into account for Section 965 purposes by the Parent-A Group during its Election Period.

C. USSH-T is Disposed of (or Spun-Off) Prior to Parent-T's Election Period

Proposed Rules:

1. General Rule – Apportionment Based Upon Post-Acquisition Ownership of the Parent-T Group's CFCs (or "Proportionate Inheritance"):

USSH-T takes with it the portion of the Parent-T Group's Base Period Distribution history and APB 23 Amount that is attributable to the CFCs owned by USSH-T immediately after the acquisition, whether the transaction is taxable or tax-free to the Parent-A Group. The remainder of the two amounts stay with the Parent-T Group.

2. Election-Out of Proportionate Inheritance:

If the acquisition occurs after Parent-A's Financial Statement End Date,[70] Parent-A may elect, in lieu of applying Rule 1, to inherit none of Parent-T's Base Period Distribution history and APB 23 Amount, in which case, none of the cash dividends received from the CFCs that were in the Parent-T Group may be taken into account by

[70] As discussed above, an alternative election-out cut-off date would be the last day of Parent-A's Base Period.

Parent-A during its Election Period. The amounts are still eliminated from Parent-T's remaining amounts.

3. Special Rules Relating to APB 23 Amount Apportionment for Acquisitions Prior to Parent-A's Financial Statement End Date:

a. If the acquisition occurs prior to Parent-A's Financial Statement End Date (whether it is before or after Parent-T's Financial Statement End Date), Parent-A does not inherit any APB 23 Amount, but Parent-T does inherit its proportion of Parent-T's Base Period Amount.

b. If Rule 3.a applies, but the transaction occurs after Parent-T's Financial Statement End Date, Parent-T's APB 23 Amount is reduced by the amount which USSH-T otherwise would have taken with it.

4. Special Rules for Acquisitions after Parent-A's Financial Statement End Date

a. If the transaction occurs prior to Parent-T's Financial Statement End Date and Parent-A does not elect out of proportionate inheritance, Parent-A either (a) inherits the APB 23 Amount shown on Parent-T's last pre-acquisition "applicable financial statement" with respect to the CFCs owned by USSH-T immediately after the acquisition, or (b) computes an APB 23 Amount for those CFCs by averaging the APB 23 Amount shown on Parent-T's last pre-acquisition "applicable financial statement" and the APB 23 Amount shown on Parent-A's first post-acquisition "applicable financial statement" with respect to those CFCs.

b. If Parent-A had no APB 23 Amount or an ABP23 Amount of less than $500 million, such that it would have been using the $500 million, Parent-A may not add the inherited amount to its $500 million amount. Instead, it may aggregate the two amounts and if the sum exceeds $500 million, it may use that amount; if not, it is limited to $500 million.

c. If one of the groups had an earnings-permanently invested-abroad amount and the other had a deferred taxes amount, the deferred taxes amount would be converted to a permanently invested-abroad amount (in the manner provided by the statute) and then the appropriate two amounts would be combined.

5. Special Rule For Acquisitions After Parent-T's Financial Statement End Date:

If the disposition occurs after Parent-T's Financial Statement End Date and Parent-T would have been using the $500 million minimum, its $500 million minimum must be reduced by the amount allocated to USSH-T. The portion of the $500 million allocated to each of Parent-T's CFCs equals $500 million times the accumulated earnings and profits of the CFC as of the Financial Statement End Date divided by the accumulated earnings and profits of all of the CFCs included in the Financial Statements.

6. Application of Rules Where USSH-T is Spun-off:

Rules 1 and 5 apply. If the spin-off is prior to USSH-T's Financial Statement End Date but after Parent-T's Financial Statement End Date, Rule 3.a applies.

D. USSH-T is Acquired (or Spun-Off) During Parent-T's Election Period

Proposed Rules:

1. General Rule – USSH-T and its CFCs Are Ignored by Parent-A For All Section 965 Purposes:

Parent-A does not inherit any of Parent-T Group's Base Period Distribution history or APB 23 Amount, whether the transaction is taxable or tax-free to the shareholders of Parent-T, and no distributions made by the CFCs that are owned by USSH-T immediately after the acquisition may be taken into account by the Parent-A Group during its Election Period.

2. General Rule – Parent-T Must Retain All Attributes Attributable to USSH-T:

Parent-T may not eliminate the Base Period and APB 23 Amounts attributable to the CFCs owned by USSH-T.

E. Parent-T Disposes Of (or Spins-Off) CFC-T At Any Time[71]

Proposed Rules:

1. Rules for Parent-T:

a. If disposition occurs prior to Parent-T's Financial Statement End Date, Parent-T eliminates the Base Period Amount attributable to CFC-T.

b. If disposition occurs after Parent-T's Financial Statement End Date but prior to Parent-T's Election Period, Parent-T may elect to either (i) retain both the Base Period Amount and APB 23 Amount attributable to CFC-T or (ii) eliminate both amounts.

c. If the disposition occurs after Parent-T's Election Period has commenced, Parent-T must retain both the Base Period Amount and APB 23 Amount attributable to CFC-T.

2. Rules for Parent-A:

a. General Rule: Parent-A does not inherit any Base Period Amount or APB 23 Amount.

b. If acquisition occurs after Parent-A's Financial Statement End Date, Parent-A may not take into account any dividends from CFC-T for Section 965 purposes.

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[71] For purposes of these rules, a disposition of USSH-T with a Section 338(h)(10) election such that USSH-T is treated as if it sold the shares in CFC (or a tiered Section 338 election such that both USSH-T and CFC are treated as having sold all of their assets) should be the treated the same as a disposition of the shares of CFC-T.

II. Adjustments to Amounts of RPI (Related Party Indebtedness)

Proposed Rules:

1. Rules for Parent-T:

a. Where Parent-T disposes of USSH-T (that owns CFC-T) or of CFC-T prior to Parent-T's Election Period, Parent-T eliminates CFC-T's RPI from its October 3, 2004 RPI.

b. Where Parent-T disposes of USSH-T (that owns CFC-T) or of CFC-T during Parent-T's Election Period, Parent-T may elect to either (i) eliminate CFC-T's RPI from its October 3, 2004 RPI and not take into account any dividends received from CFC-T for Section 965 purposes, or (ii) add to its Election Period end date RPI, the RPI of CFC-T immediately prior to the disposition (in which case it may take into account any Election Period dividends received from CFC-T).

2. Rule for Parent-A If Parent-A Group Acquires Parent-T Group Prior to Parent-T's Election Period:

Parent-A inherits Parent-T Group's October 3, 2004 RPI.

3. Rules for Parent-A if Parent-A Group Acquires USSH-T (owning a CFC)

a. If Parent-A is inheriting the Base Period and APB 23 Amounts attributable to the CFCs owned by USSH-T, Parent-A must add to its October 3, 2004, the RPI the RPI of those CFCs immediately after the acquisition.

b. If Parent-A is not inheriting the Base Period and APB 23 Amounts attributable to the CFCs owned by USSH-T, Parent-A excludes those CFCs' RPI from Parent-A's Election Period end date RPI (and, as provided for in the prior rules, may not take into account any dividends received from CFC for Section 965 purposes).

4. Rule for Parent-A if Parent-A Group Acquires CFC-T:

No adjustment is made to Parent-A's October 3, 2004 RPI.

5. Rules for USSH-T Which Becomes a Standalone Corporation or The Parent of A New Consolidated Group:

a. If USSH-T is taking with it the Base Period and APB 23 Amounts attributable to the CFCs owned by USSH-T, USSH-T must create a start-date RPI equal to the RPI of those CFCs immediately after the acquisition.

b. If USSH-T is not taking with it the Base Period and APB 23 Amounts attributable to the CFCs owned by USSH-T, USSH-T's RPI would not matter because, as provided for in the prior rules, USSH-T would have already participated in Parent-T's Election Period.