New York State Bar Association

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May 25, 2005

Mr. Eric Solomon
Acting Deputy Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3104 MT
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Mark W. Everson
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Acting Deputy Assistant Secretary Solomon and Commissioner Everson:

I am pleased to submit the New York State Bar Association Tax Section's Report No. 1087, which comments on various issues relating to recently enacted section 965 of the Internal Revenue Code of 1986, as amended, and the recent guidance published by the Treasury Department and the Internal Revenue Service in Notices 2005-10 and 2005-38 (the "Notices"). The Report supplements our December 14, 2004 letter with respect to section 965 generally and our March 18, 2005 report addressing certain issues that arise in the mergers and acquisitions context.

As an initial matter, we would like to commend the Treasury Department and the Internal Revenue Service for the timely guidance provided by the Notices. In general, we endorse most of their general principles and specific guidance. The Report, however, sets forth several recommendations regarding section 965 and the guidance provided in the Notices.

In general, subject to a number of qualifications and restrictions, section 965 allows a domestic corporation to claim an 85-percent dividends received deduction with respect to certain dividends ("qualifying dividends") it receives from controlled foreign corporations in which it is a U.S. shareholder, provided that the dividend is invested in "permitted investments" in accordance with a domestic reinvestment plan. Notice 2005-10 provides guidance with respect to the requirements regarding a domestic reinvestment plan described in section 965(b)(4). Notice 2005-38 addresses the limitations, described in sections 965(b)(1), (2), and (3), on the amount of dividends that a U.S. shareholder of a controlled foreign corporation may treat as qualifying dividends, including the effects of certain transactions on such limitations. Among other things, the Report recommends that:

- The term cash dividend for purposes of section 965(a) should be expanded to include certain cash equivalents.

- For purposes of section 965(b), certain adjustments should be allowed to account for foreign taxes imposed upon earnings where the amount of the qualifying dividend is limited by reference to the amount of the deferred tax liability.

- For purposes of the calculation required by section 965(b)(3), U.S. shareholders should be allowed to net any increase in the related party indebtedness of their controlled foreign corporations against any increase in the amount that they owe to such related controlled foreign corporations.

- Foreign tax credits attributable to the deductible portion of a qualifying dividend should be treated as having been distributed out of income in a separate category in the same proportion as applies for section 904 purposes generally.

- More specific guidelines and criteria should be issued regarding the level of detail and specificity required of a domestic reinvestment plan.

- Taxpayers should be allowed to amend a domestic reinvestment plan provided there has been a material change in circumstances.

- Repayment of debt should not be deemed to contribute to financial stabilization if the taxpayer has a present intention to incur "replacement debt" in the near future, even if the replacement debt has different terms. Rather, step-transaction principles should apply such that the taxpayer's ability to qualify for a deduction under section 965(a) should be measured by reference to the use of the proceeds of the replacement debt.

- The payment of a tort liability should constitute a permitted investment to the extent that such payment contributes to financial stabilization.

- Where a taxpayer is required to reverse a portion of a deduction previously claimed under section 965, in most situations, the taxpayer should not be subject to penalties and should only be liable for the tax due plus interest.

- In the case of reliance on the safe-harbor rule contained in Notice 2005-10, amounts not expended on permitted investments should not be eligible for the section 965(a) deduction merely because the taxpayer had a reasonable expectation that they would be so expended.

We appreciate your consideration of our proposals and the issues we have addressed in the Report. As always, we would be pleased to discuss these matters with you further or provide any other assistance that you would find helpful.

Respectfully submitted,

David P. Hariton

David P. Hariton
Chair

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