**NEW YORK STATE BAR ASSOCIATION**

**TAX SECTION**

# Report on Section 965 and Notices 2005-10 and 2005-38

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# New York State Bar Association Tax Section
# Report on Section 965 and Notices 2005-10 and 2005-38

This report, prepared by an ad hoc committee of the New York State Bar Association Tax Section,[1] comments on various issues relating to recently enacted section 965.[2] In particular, it 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 ("Treasury") and the Internal Revenue Service (the "Service") for the timely guidance provided by Notice 2005-10[3] and Notice 2005-38[4] (collectively, the "Notices"). Given the limited window of opportunity for taxpayers to take advantage of section 965, we believe that such guidance is extremely important and we look forward to the additional guidance promised by the Notices.

## I. Background

Section 965(a), which was enacted as part of the American Jobs Creation Act of 2004,[5] allows a domestic corporation to claim an 85-percent dividends received deduction with respect to certain dividends ("qualifying dividends") it receives from controlled foreign

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1 The principal drafters of this report were Douglas R.A. McFadyen and Michelle L. Petock. Significant contributions were received from Kim Blanchard, Peter Blessing, Peter Connors, David Hariton, Yaron Reich, and Diana Wollman. Other members of the ad hoc committee were Joseph Czajkowski, Marc Ganz, Kevin Glenn, Deborah J. Goldstein, David Grech, Deborah Jacobs, Daniel Kheel, Thomas May, David Miller, Stephen Mills, John Narducci, Yuval Navot, Elaine Platt, Jonathan Stevens, and Linda Swartz.

2 Except as otherwise indicated, all section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or to the Treasury regulations promulgated thereunder.

3 Notice 2005-10, 2005-6 I.R.B. 474 ("Notice 2005-10").

4 Notice 2005-38, 2005 WL 1090135 ("Notice 2005-38").

5 Pub. L. No. 108-357, 108th Cong., 2d Sess. (2004), § 422.

corporations in which it is a U.S. shareholder.[6] All corporations that are members of an affiliated group filing a consolidated return under section 1501 are treated as a single shareholder for purposes of the provision.[7] A U.S. shareholder may elect the application of section 965 for either its last taxable year that begins before October 22, 2004, or its first taxable year that begins during the one-year period beginning on October 22, 2004 (in each case, an "election year").[8] Such election must be made on a timely filed return (including extensions) for the election year.[9]

The stated purpose of section 965 is to stimulate the U.S. economy by encouraging the repatriation of foreign earnings that otherwise would have remained invested outside the United States.[10] The legislative history to the provision emphasizes that it is a temporary economic stimulus measure, and that there is no intent to make the deduction "permanent" by extending it or enacting it again in the future.[11]

In addition to the temporal limitations noted above, there are a number of qualifications and restrictions with respect to the availability of the deduction. The more significant of these generally can be summarized as follows:

1. Distributions constitute qualifying dividends only to the extent that they are paid in cash and included in income under U.S. federal income tax principles as dividends. A dividend for this purpose also includes a cash distribution from a controlled foreign corporation that, while excluded from gross income under section 959(a), is attributable to an amount included in income under section 951(a)(1)(A) as a result of a cash

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6 I.R.C. § 965(a).

7 I.R.C. § 965(c)(5)(A).

8 I.R.C. § 965(f).

9 Id.

10 Conf. Rep. No. 108-755 (2004) (hereinafter, the "Conference Report").

11 Id.

dividend during the election year to: (i) such controlled foreign corporation from another controlled foreign corporation in a section 958(a) chain of ownership; or (ii) any other controlled foreign corporation in such chain of ownership to the extent of cash distributions described in section 959(b) made during such year to the controlled foreign corporation from which the U.S. shareholder received the distribution.[12]

2. The amount of otherwise qualifying dividends is reduced by any increase in the aggregate "related party indebtedness" of the controlled foreign corporations (taken together) with respect to which a taxpayer is a U.S. shareholder. For this purpose, "related party indebtedness" means indebtedness of a controlled foreign corporation to a related person, as defined in section 954(d)(3), other than another controlled foreign corporation. The increase is measured from the close of October 3, 2004 to the close of the election year.[13]

3. The amount of qualifying dividends is limited to the greater of $500 million or the amount of income shown on an "applicable financial statement" as permanently invested outside the United States (or, in some cases, the amount of the deferred tax liability corresponding to such income divided by 0.35).[14] An applicable financial statement is generally defined as the most recently audited financial statement (including any notes and other documents that accompany such statement) that included the U.S. shareholder and that is certified on or before June 30, 2003 as being prepared in accordance with generally accepted accounting principles and used for purposes of reporting to creditors or shareholders or for any other substantial non-tax purpose.[15] In the case of a corporation required to file a financial statement with the Securities and Exchange Commission, an applicable financial statement is defined as the most recent such statement filed with the Securities and Exchange Commission on or before June 30, 2003.[16]

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12 I.R.C. § 965(a)(2). Qualifying dividends do not include amounts includible in gross income as a dividend under section 78, 367 or 1248 (except to the extent a U.S. shareholder actually receives cash as part of a section 332 liquidation to which section 367(b) applies). I.R.C. § 965(c)(3).

13 I.R.C. § 965(b)(3).

14 I.R.C. § 965(b)(1).

15 I.R.C. § 965(c)(1). Notice 2005-38 specifically notes that items, such as work papers, that do not form an integral part of a financial statement do not constitute part of an applicable financial statement.

16 Id.

4. Dividends are treated as qualifying dividends only to the extent that the aggregate amount of dividends received by the U.S. shareholder from all controlled foreign corporations during the election year exceeds the average annual repatriations received by the U.S. shareholder from all such controlled foreign corporations during a base period (the "base period amount"). The base period generally consists of three of the five most recent taxable years ending on or before June 30, 2003, determined by disregarding the years with the highest and lowest repatriations.[17] If the U.S. shareholder has fewer than five taxable years ending on or before June 30, 2003, then the base period includes all of the taxable years of the U.S. shareholder ending on or before such date.[18]

5. In order to constitute a qualifying dividend, a dividend (or an equivalent amount) must be invested in accordance with a "domestic reinvestment plan" which is timely approved and provides for the investment of the dividend (or equivalent amount) in the United States (other than as payment of executive compensation) including as a source for the funding of worker hiring and training, infrastructure, research and development, capital investments, or the financial stabilization of the corporation for the purposes of job retention or creation (hereinafter, a "permitted investment").[19]

The statute further provides that no credit is available under section 901 for any foreign taxes that relate to the deductible portion of a qualifying dividend.[20] Additionally, no deduction is allowed for expenses properly allocated and apportioned to the deductible portion of a qualifying dividend.[21] Significant limitations are also imposed on the attributes available to offset the nondeductible portion of a qualifying dividend.[22]

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17 I.R.C. § 965(b)(2).

18 I.R.C. § 965(c)(2)(B).

19 I.R.C. § 965(b)(4).

20 I.R.C. § 965(d)(1).

21 I.R.C. § 965(d)(2).

22 I.R.C. § 965(e).

The proposed Tax Technical Corrections Act of 2004 (the "Technical Corrections Act") includes several amendments to section 965.[23] The Technical Corrections Act would amend section 965 by, among other things: (i) providing the Service with the authority to promulgate regulations to prevent potential abuses of the related party indebtedness rule (item 2 above); (ii) specifying that only cash dividends paid during the election year be taken into account in determining whether or not the amount of dividends received during the election year exceeds the base period amount (item 4 above); and (iii) amending the definition of applicable financial statement to include only audited financial statements in the case of a corporation that is required to file with the Securities and Exchange Commission (item 3 above). The proposed legislation would also provide that section 78, which requires an income inclusion equal to the amount of foreign taxes deemed paid under section 902 in respect of dividends received from a controlled foreign corporation, does not apply with respect to the deductible portion of a qualifying dividend. It would further provide that a deduction is denied only for expenses "directly" allocable, as opposed to those "properly allocated and apportioned", to the deductible portion of the qualifying dividend.[24]

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23 H.R. 5395, 108th Cong. 2d Sess. (2004), § 7; S. 3019, 108th Cong., 2d Sess. (2004).

24 In preparing this report, we have assumed that the provisions of the Technical Corrections Act relating to section 965 will be enacted in the form currently proposed. In the absence of such enactment, we believe that the purposes of section 965 would be substantially frustrated. For example, as noted above, the Technical Corrections Act would amend the definition of applicable financial statement, in the case of a corporation that is required to file a financial statement with the Securities and Exchange Commission, to include only those financial statements that are audited. In the absence of that change, many U.S. shareholders seeking to repatriate would be limited to the $500 million floor amount in section 965(b)(1). This is because for the majority of U.S. shareholders the most recent financial statement filed with the Securities and Exchange Commission prior to June 30, 2003 would be a quarterly financial statement filed with Form 10-Q and, unlike the annual financials filed with Form 10-K, quarterly financials typically would not show an amount as permanently invested outside the United States or a tax liability corresponding to such amount. We would recommend that the Service issue guidance regarding matters relating to the Technical Corrections Act on the basis that the provisions will be enacted in the form proposed, with such guidance (whether it be via Notice or regulations) becoming effective upon enactment of the bill. Under this approach, taxpayers will have guidance with respect to issues, such as the allocation of expenses, in sufficient time to take advantage of section 965.

Guidance on a wide range of issues relating to section 965 was issued in the Notices. Notably, Notice 2005-10 sets forth general principles and specific guidance with respect to domestic reinvestment plans and permitted investments, certain election and reporting requirements, rules for demonstrating that dividend proceeds have been invested in the United States pursuant to a domestic reinvestment plan (including a safe-harbor for making such a demonstration), and transition rules for taxpayers that have adopted a domestic reinvestment plan and received a dividend, or filed a tax return, for a prior taxable year. Notice 2005-38 primarily addresses the limitations, described in sections 965(b)(1), (2), and (3), on the amount of dividends that a U.S. shareholder may treat as eligible for the dividends received deduction under section 965(a), including the effects of certain transactions on such limitations.

The Notices state that additional guidance on a variety of issues, such as foreign tax credit and expense allocation, will be forthcoming. Our recommendations in this report relate both to issues addressed in the Notices and to issues that we expect will be the subject of future guidance.

## II. Summary of Recommendations

We have the following recommendations regarding section 965 and the guidance provided by Treasury and the Service in the Notices:

1. Notice 2005-10 concludes that a deduction under section 965(a) is available only for distributions of U.S. dollars and foreign currency. We believe that this definition is unduly narrow and that the term "cash dividend" should be interpreted to include certain cash equivalents. Specifically, we recommend that distributions of Class I and Class II assets (other than shares) qualify as cash dividends for section 965 purposes. Alternatively, we request that the Service provide further guidance regarding the additional factors that would be relevant in determining when a cash dividend would be recharacterized as a non-cash dividend.

2. Notice 2005-38 states that where the amount of qualifying dividends is limited under section 965(b)(1) by reference to the amount of the deferred tax liability shown on the applicable financial statement as attributable to earnings permanently reinvested offshore, no adjustment is to be made for any foreign taxes imposed on such earnings. We believe that this generally causes the amount that is, in effect, permanently reinvested offshore to be understated and that the amount of any deferred tax liability should be increased to reflect the credit available under section 901 for any foreign taxes paid or accrued with respect to such earnings (with an additional offset to reflect any section 78 amounts that ordinarily would be attributable to any U.S. foreign tax credit reflected in the calculation). We also believe that where the potential amount of a qualifying dividend is determined, in whole or in part, by reference to the amount of a foreign deferred tax liability, the limitation otherwise determined under section 965(b)(1) should be reduced by the amount of the deferred foreign tax liability.

3. Notice 2005-38 provides that, in determining the amount of related party indebtedness of a controlled foreign corporation for purposes of section 965(b)(3), no offset is permitted for any indebtedness of any related person to the controlled foreign corporation. We believe that this position is inconsistent with the policy underlying section 965(b)(3) and, accordingly, we request that the Service reconsider its position in this regard and allow a U.S. shareholder to net any increase in related party indebtedness during the measurement period against any increase during the measurement period in the aggregate amount that it owes to related controlled foreign corporations. We further recommend that the Service clarify that section 965(b)(3) does not apply to debt owed by a controlled foreign corporation to a foreign parent of the U.S. shareholder, or to another related party that is not a domestic corporation or other U.S. entity.

4. Taxpayers are able to claim a foreign tax credit only for that portion of any foreign taxes attributable to the non-deductible portion of a qualifying dividend. At present, there is no guidance on how to allocate the foreign tax attributable to the deductible and non-deductible portions among the various foreign tax credit baskets. In our view, 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.

5. Notice 2005-10 provides that a domestic reinvestment plan must describe the planned U.S. investment of any dividends otherwise qualifying for deduction under section 965(a) in "reasonable detail and specificity". We believe that more guidance is needed with respect to that standard. In particular, while we understand that it may not be desirable, or even feasible, to establish a single template that would be applicable to all taxpayers, given the importance of the concept we believe that it is appropriate to provide more specific guidelines and criteria for taxpayers to follow. Descriptive examples of plans that would not meet the reasonable detail and specificity standard would be particularly helpful.

6. Notice 2005-10 prohibits the amendment of a domestic reinvestment plan once the section 965(a) distribution has been made (except to implement a limited transition rule). Implicit in the policy underlying section 965 is that the amounts being repatriated be invested in productive activities. Requiring taxpayers to make investments that, due to changes in circumstances, are no longer economically viable is inconsistent with that policy goal. Accordingly, we believe that taxpayers should be allowed to amend a domestic reinvestment plan provided there has been a material change in circumstances.

7. Notice 2005-10 provides that expenditures incurred in connection with funding the hiring and training of workers are permitted investments to the extent attributable to services performed within the United States. Where services are performed by non-employees, a taxpayer may not have the ability directly to ascertain where the services are being performed. In such cases, we believe that, absent actual knowledge or reason to know, the taxpayer should be able to rely upon the certification of the service provider as to where the services were performed.

8. Notice 2005-10 provides that so long as a repayment of debt contributes to the financial stabilization of the taxpayer for the purposes of job retention or creation in the United States, the repayment is a permitted investment unless the taxpayer has a plan or intention to incur additional debt on substantially the same terms following the date of the dividend, and the taxpayer in fact incurs such additional debt. While we agree with the policy underlying this rule, we believe that the rule itself is cast too narrowly. In particular, where a taxpayer repaying the debt has a plan or intention to incur additional debt in the near future such that the reduction in debt is, in effect, merely

transitory, we do not think the mere fact that the replacement debt is not incurred on substantially the same terms as the original debt warrants allowing the repayment to be treated as contributing to financial stabilization. Step-transaction principles might be followed, however, to allow the dividend to qualify by reference to the use of proceeds of the replacement indebtedness.

9. In at least a number of instances it is likely that, if able to do so, taxpayers would use at least a portion of any amounts repatriated to pay anticipated tort liabilities. We believe that tort liabilities are, at least in the section 965 context, essentially no different from other business liabilities. Accordingly, we recommend that the Service clarify that the payment of tort liabilities qualifies as a permitted investment to the same extent as the payment of indebtedness generally.

10. Notice 2005-10 indicates that if the amount that a U.S. shareholder expends on permitted investments pursuant to a domestic reinvestment plan is less than the amount provided for in the plan, the amount of the dividend qualifies only to the extent of the amount so expended. Notice 2005-10 does not, however, provide any guidance as to the collateral consequences where a taxpayer is required to reverse a portion of a deduction previously claimed under section 965. We believe that, in most situations, the taxpayer should not be subject to penalties as a consequence of failing to invest the entire dividend amount but should be liable for the tax due with respect to the uninvested portion plus interest.

11. Notice 2005-10 provides that the amount of a dividend will be deemed to have been invested in the United States pursuant to a dividend reinvestment plan where, among other things, at least 60 percent of the amount of the dividend is so invested by the end of the second year following the election year and the taxpayer makes certain certifications to the effect that it intends to invest the remaining 40 percent by no later than the end of the fourth taxable year following the election year. We believe that this safe-harbor rule could be interpreted too broadly and that the Service should clarify that amounts not expended on permitted investments are not eligible for the section 965(a) deduction merely because the taxpayer had a reasonable expectation that they would be so expended.

## III. Discussion

### A. Cash Dividends

Section 965(a) provides that only "cash" distributions taxable as dividends for U.S. federal income tax purposes are eligible for the section 965(a) deduction.[25] Attempts made prior to enactment by certain members of the House to extend the benefits of the temporary dividends received deduction to repatriations of property other than cash and to certain deemed dividends were not successful.[26]

Notice 2005-10 defines the term "cash" for purposes of section 965(a) to include only U.S. dollars and foreign currency.[27] We recommend that the Service reconsider this limited definition of cash and, instead, provide guidance indicating that, for purposes of section 965(a), "cash" also include certain cash equivalents.

The exclusion of cash equivalents from the definition of cash will in many, if not most, cases require the disposition of securities and other cash equivalents at the controlled foreign corporation level in order to pay a cash dividend. Where the amount of the dividend is immediately reinvested pursuant to a domestic reinvestment plan, there are no incremental costs associated with such a disposition. Given the amounts involved, however, we expect that most taxpayers frequently will invest the amount being repatriated only over a period of years. In the

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[25] I.R.C. § 965(a). As noted above, a cash dividend also includes a cash distribution from a controlled foreign corporation that, while excluded from gross income under section 959(a), is attributable to an amount included in income under section 951(a)(1)(A) as a result of a cash dividend during the election year to: (i) such controlled foreign corporation from another controlled foreign corporation in a section 958(a) chain of ownership; or (ii) any other controlled foreign corporation in such chain of ownership to the extent of cash distributions described in section 959(b) made during such year to the controlled foreign corporation from which such U.S. shareholder received the distribution.

[26] See 150 Cong. Reg. H. 4393 (2004) at H4412 et seq. for a proposal that the preferential rate be available to the excess of aggregate dividends received from controlled foreign corporations over a base dividend amount. For this purpose, the term "dividend" would have been defined to mean a dividend as defined in section 316 and amounts described in section 951(a)(1)(B), excluding amounts described in section 78.

[27] Notice 2005-10 at § 3.01.

interim, such amounts will likely be reinvested in the same, or similar, cash equivalents as were liquidated by the controlled foreign corporation. As discussed below, Notice 2005-10 itself acknowledges that such liquidation and reinvestment may be a common pattern in the section 965 context.[28]

We see no obvious policy rationale for requiring taxpayers to incur the costs associated with such a liquidation and reinvestment exercise. We also believe that, by facilitating the ability of taxpayers to repatriate funds, expansion of the definition of cash to include certain cash equivalents would advance the underlying policy of section 965. Further, because any non-cash distribution generally can be expected to be converted to cash within a reasonable period of time in order to satisfy the general investment requirements of section 965, we do not believe that such a rule would be susceptible to abuse.

While the definition of cash equivalents found in Treasury regulation section 1.897-7T(a), and specifically referenced in Notice 2005-10, may cast too broad a net in that it includes items such as commodities and precious metals, we believe that a workable approach would be to begin by adopting a definition of "cash" that encompasses the assets described in Treasury regulation section 1.338-6(b) as Class I and Class II assets. Pursuant to that regulation, Class I and Class II assets include cash, general deposit accounts (including savings and checking accounts), certificates of deposit, foreign currency, and actively traded personal property within the meaning of section 1092(d)(1) and Treasury regulation section 1.1092(d)-1 (determined without regard to section 1092(d)(3)).[29]

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[28] Notice 2005-10 at § 3.01.

[29] Treas. Reg. § 1.338-6(b). We would, however, exclude publicly traded stock as a cash equivalent.

We understand that the Service is concerned that it lacks the authority to treat distributions of cash equivalents as "cash dividends." We emphasize, however, that Notice 2005-10 treats foreign currency – clearly a type of cash equivalent and itself a Class II asset – as "cash" for section 965 purposes. Given that, we believe that the Service should equally be able to treat other types of Class II assets as cash for section 965 purposes.

In the event that the foregoing recommendation is not adopted, we request that the Service provide further guidance regarding the additional factors that would be relevant in determining when a cash dividend would be recharacterized as a non-cash dividend. In this regard, while Notice 2005-10 states that the fact that a controlled foreign corporation held cash equivalents prior to a distribution, and the particular U.S. shareholder held similar cash equivalents after the distribution, will not, in itself, cause the Commissioner to recharacterize the dividends as a distribution of cash equivalents under the step transaction doctrine or similar principles,[30] it does not give any guidance regarding what additional facts would prompt such a recharacterization. For example, would a transaction be subject to recast where a U.S. shareholder borrows funds to purchase cash equivalents from a controlled foreign corporation, followed by the controlled foreign corporation's use of the sale proceeds to pay a section 965 dividend to the U.S. shareholder and the U.S. shareholder's use of the funds to repay the borrowing? If so, would the same result obtain where a controlled foreign corporation sells cash equivalents, distributes the proceeds to its U.S. shareholder and the U.S. shareholder uses the funds to purchase the same or identical cash equivalents from a third-party?

While in certain contexts the transactions in each of the foregoing scenarios would properly be subject to recharacterization, given the underlying policy of section 965, and

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[30] Notice 2005-10 at § 3.01.

the fact that any investment in cash equivalents generally can be expected to be temporary, we believe that, at least where the cash equivalents in question constitute Class I or Class II assets, the transaction should not be subject to recast for section 965 purposes. In any event, in view of the normality of investing amounts that are earmarked for future expenses in cash equivalents and other temporary investments, as well as the costs associated with a recharacterization, we feel that it is important for the Service to provide taxpayers with specific guidance regarding the potential application of substance-over-form principles to recast cash dividends as non-cash dividends.

B. Dividend Limitations and Applicable Financial Statements

Section 965(b)(1) imposes a cap on the dollar amount of qualifying dividends. Pursuant to that section, the amount of otherwise qualifying dividends is limited to the greater of $500 million or the amount shown on the applicable financial statement with respect to the U.S. shareholder as "earnings permanently reinvested" outside the United States.[31] The "applicable financial statement" in respect of a U.S. shareholder generally is defined as the most recently audited financial statement that included the U.S. shareholder and that was certified on or before June 30, 2003, as being prepared in accordance with generally accepted accounting principles and used for purposes of reporting to creditors or shareholders or for any other substantial non-tax purpose.[32] In the case of a corporation that is required to file a financial statement with the Securities and Exchange Commission, the term "applicable financial statement" is defined as the most recent financial statement filed with the Securities and Exchange Commission on or before

[31] I.R.C. §§ 965(b)(1)(A) and (B). The concept of "earnings permanently reinvested" outside the United States derives from Accounting Principles Board Opinion 23, which excepts U.S. tax liability on undistributed earnings of foreign subsidiaries and foreign corporate joint ventures from the general rule requiring recognition of temporary book-tax differences if such liability meets a specified criterion for indefinite deferral. See H.R. Conf. Rep., at 67 n. 111.

June 30, 2003.[33] As noted previously, the Technical Corrections Act would amend this definition in several regards. Most significantly, it would clarify that the applicable financial statement filed with the Securities and Exchange Commission must be the most recent "audited" statement so filed.[34]

In the case of an applicable financial statement that fails to show a specific amount of earnings permanently reinvested outside the United States, but which does show a specific amount as a tax liability attributable to such earnings (i.e., those permanently reinvested offshore but not identified as such on the applicable financial statement), the statute provides that the amount available for deduction is determined by dividing the amount of such deferred tax liability by 0.35.[35] Implicit in this rule is the assumption that, upon repatriation, the amount of earnings permanently reinvested offshore will be subject to tax at a 35 percent rate. Our principal concern with this provision relates to the fact that where the income in question has been subject to foreign tax, it is erroneous to assume that tax will be paid on the underlying income at a 35 percent rate when the income is distributed to the U.S. shareholder. Rather, because it is determined by taking into account the availability of a foreign tax credit attributable to the underlying foreign tax, the deferred tax liability includes only the incremental U.S. tax liability. As a result, where the foreign income in question has been subject to a creditable foreign income tax, the amount available for distribution by the controlled foreign corporation will tend to be understated.

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32 I.R.C. § 965(c)(1).

33 Id.

34 Supra at p. 5.

35 I.R.C. § 965(b)(1)(C).

A less obvious concern with the rule is the fact that it looks to "the amount of tax liability" (i.e., both domestic and foreign) attributable to the particular earnings, and not merely to the amount of U.S. federal income tax liability. As a result, the amount available for distribution by a controlled foreign corporation will tend to be overstated where there is a deferred foreign income tax liability associated with the earnings. The scope of this problem may be illustrated by the following example:

> X is a controlled foreign corporation in a high tax jurisdiction (e.g., a 50% tax rate) that derives $100 of income. The tax liability with respect to such income is not payable until a future year. As X will be required to retain sufficient funds to meet its foreign tax liability, as an economic matter it will have only $50 available for distribution. Because, however, the applicable financial statement will show a deferred tax liability of $50, the U.S. shareholder with respect to X would be able to claim $142.86 (i.e., $50/0.35) as its section 965(b)(1) limitation amount.

The amount of the overstatement in the foregoing example potentially has two sources: the fact that the rate of foreign tax exceeds 35 percent and the fact that, unlike U.S. tax, the foreign tax reduces the amount available for distribution. Thus, as illustrated by the following example, an issue exists even where the foreign tax rate is less than 35 percent.

> X is a controlled foreign corporation in a low tax jurisdiction (e.g., a 20% tax rate) that derives $100 of income. Again, the tax liability with respect to such income is not payable until a future year. Net of the $20 needed to satisfy the deferred tax liability, X will have $80 available for distribution. Because, however, the applicable financial statement will show a deferred tax liability of $35 (i.e., $20 of foreign tax and $15 of residual U.S. federal income tax), the U.S. shareholder with respect to X would be able to claim $100 (i.e., $35/0.35) as its section 965(b)(1) limitation amount.

While we understand that an objective of the approach taken in the statute was to avoid any need to look to the work papers accompanying the applicable financial statement, we believe that, consistent with the position taken in Notice 2005-38 for purposes of allocating the

APB 23 limitation, reference to work papers for the limited purpose of determining the amount of underlying tax should be permitted in the interest of fairness. In this regard, we would suggest that a technical correction be sought to allow taxpayers to increase the amount of any deferred tax liability shown on the applicable financial statements by the amount of the U.S. foreign tax credit reflected in computing such U.S. tax liability (subject to a corresponding decrease in the amount available for deduction under section 965 for both the amount of any deferred foreign tax liabilities and the section 78 amounts that would be attributable to any U.S. foreign tax credit reflected in the calculation). Thus, on the facts of the above example, the limitation amount as determined under the present rule (i.e., $100) would be reduced by the amount of the foreign deferred tax liability (i.e., $20), thereby eliminating the amount of the overstatement.[36]

The question of how to deal with situations where the income of the controlled foreign corporation has been taxed at a rate in excess of 35 percent is a more difficult one. To begin with, the fact that a particular controlled foreign corporation has an effective tax rate in excess of 35 percent does not necessarily result in the overall amount available for repatriation being overstated. This is because the tax paid by the particular controlled foreign corporation may, in many instances, be used to shelter low-taxed income derived by another controlled foreign corporation. Moreover, the fact that a controlled foreign corporation may pay dividends only to the extent of current and accumulated earnings and profits serves as a practical limit on the ability to take advantage of any overstatement. As a general policy matter, however, we would support revising section 965(b)(1) to address those situations in which differences

[36] Under our recommendation, the same result would also obtain where the foreign tax was paid or accrued currently, rather than deferred.

between the effective foreign income tax rate and the assumed rate of 35 percent result in the amount potentially available for deduction under section 965(a) being overstated.

C. Related Party Indebtedness

Under section 965(b)(3), the amount of otherwise qualifying dividends is reduced by any increase in a controlled foreign corporation's related party indebtedness. Specifically, the amount of the dividends is reduced by the excess, if any, of: (i) the amount of indebtedness of the controlled foreign corporation owed to any related person as of the close of the election year, over (ii) the amount of indebtedness of the controlled foreign corporation owed to any related person as of the close of October 3, 2004.[37] For purposes of this rule, all controlled foreign corporations with respect to which the taxpayer is a U.S. shareholder are treated as one controlled foreign corporation.[38] Thus, indebtedness between such controlled foreign corporations is disregarded for purposes of the determination. A "related" person is as defined in section 954(d)(3).[39] This generally includes any person that, by ownership of shares representing more than 50 percent by vote or value, controls, is controlled by, or is under common control with, the controlled foreign corporation (with similar concepts for non-corporate entities).[40]

The Conference Report indicates that this rule is intended to prevent a deduction from being claimed in cases in which the U.S. shareholder directly or indirectly (e.g., through a related party) finances a dividend from a controlled foreign corporation – such that there is no

37 I.R.C. § 965(b)(3). Notice 2005-38 provides that, as a matter of administrative convenience, a U.S. shareholder may elect to measure any increase in related party indebtedness from either: (i) where the U.S. shareholder uses a calendar year or a fiscal year as its taxable year, the close of September 30, 2004 or (ii) where the U.S. shareholder uses a 52-53 week taxable year, the close of the last day of such shareholder's fiscal-year month ending nearest to October 3, 2004.

38 Id.

39 Id.

40 I.R.C. § 954(d)(3).

net repatriation of funds.[41] For this purpose, borrowings generally are treated as fungible and tracing is not allowed, with the result that any increase in related party indebtedness is taken into account.

The Technical Corrections Act would grant Treasury specific regulatory authority as follows:

> [T]he Secretary may prescribe such regulations as may be necessary or appropriate to prevent the avoidance of the purposes of this paragraph, including regulations which provide that cash dividends shall not be taken into account under subsection (a) to the extent such dividends are attributable to the direct or indirect transfer (including through the use of intervening entities or capital contributions) of cash or other property from a related person (as so defined) to a controlled foreign corporation.[42]

The Joint Committee explanation indicates that "this authority, which supplements existing principles relating to the treatment of circular flows of cash, will be used to prevent the application of the deduction in the case of a dividend that is effectively funded by the U.S. shareholder or its U.S. affiliates".[43]

Our comments regarding the operation of the foregoing rules are several. First, we believe that it is appropriate that any increase in the amount that a U.S. shareholder owes to a related controlled foreign corporation be taken into account as an offset to any increase in the amounts that the U.S. shareholder has loaned to a related controlled foreign corporation. As noted previously, section 965(b)(3) is intended to prevent a dividends received deduction in those cases where a dividend is attributable to amounts received, directly or indirectly, from a

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41 Conference Report, at 942.

42 H.R. 5395, 108th Cong. 2d Sess. (2004), § 7.

43 Joint Committee on Taxation, Description of the Tax Technical Corrections Act of 2004, (JCX-70-04), November 19, 2004, at 3.

U.S. shareholder. In this regard, a U.S. shareholder should be considered as having funded a dividend from a controlled foreign corporation only to the extent of any increase in the "net indebtedness" of the controlled foreign corporation to the U.S. shareholder. Accordingly, limiting the application of section 965(b)(3) to such net indebtedness is consistent with the goal of section 965(b)(3), namely to ensure that there is a net repatriation of funds. Because, once again, there is a net repatriation of funds to the United States, we also recommend that the Service clarify that section 965(b)(3) does not apply to debt owed by a controlled foreign corporation to a foreign parent of the U.S. shareholder, or to another related party outside the United States.

We would note that we support the grant of authority provided by the Technical Corrections Act. Specifically, expanding the scope of the Service's authority to reach transfers such as capital contributions seems particularly appropriate. In our view, a capital contribution is more objectionable from a policy perspective than a loan in that the former involves a quasi-permanent transfer of funds, whereas the latter, by its terms, must be repaid. We believe, however, that clear guidance is necessary regarding the Service's intended use of the grant of regulatory authority outlined in the Technical Corrections Act. Absent such guidance, the uncertainty created by the provision may act as a deterrent to repatriation.

Significantly, we would request that the Service adopt a clear definition of when the "attributable to" standard of the Technical Corrections Act will be satisfied. We note that although the phrase is frequently used in the tax law, it is rarely defined. As noted above, however, the Joint Committee explanation indicates that the proposed grant of regulatory authority under section 965 is intended to "prevent the application of the deduction in the case of a dividend that is effectively funded by the U.S. shareholder or its U.S. affiliates". Thus, in our

view, the "attributable to" standard should be limited to situations where a dividend is effectively funded by someone with a prohibited relationship. In that vein, the application of the rule should not be limited to situations involving a direct tracing of the funds. Instead, more subjective factors, such as the purpose of the transfer of funds, would be appear to be most relevant.

Finally, as a policy matter, we would note that it is arguably appropriate for the "attributable to" standard to apply in the context of both direct and indirect loans. We see no policy rationale why the standard applicable to a direct loan should be different from that applicable to an indirect loan or capital contribution. This is particularly true given that, as noted above, increases in the amount of equity (i.e., a quasi-permanent transfer of property offshore) would seem to be more objectionable than increases in debt (which represent only a temporary transfer). Given that a transfer such as a capital contribution is tainted only if the subsequent dividend is "attributable to" the capital contribution, a factual inquiry seems mandated, as discussed above, by the statute as to whether an impermissible nexus exists between the transfer and the dividend. It seems to us just as reasonable, if not more so, to inquire as to the purposes surrounding a loan.

D. Foreign Tax Credits

Pursuant to section 965(d)(1), no credit is allowed under section 901 for foreign taxes relating to the deductible portion of a qualifying dividend.[44] As a result, section 904 basketing issues arise in respect of the nondeductible portion of the dividend. Specifically, when calculating the amount of the foreign tax credit that may be applied against the nondeductible portion of the dividend, it is unclear how a taxpayer should determine which categories of income for purposes of section 904 are deemed used to pay the dividend.

[44] I.R.C. § 965(d)(1).

One possible approach would be to mirror the rule adopted by the statute for purposes of determining the extent to which a dividend is treated as having been paid by a particular controlled foreign corporation. Under that rule, where, for example, a U.S. shareholder receives dividends from multiple controlled foreign corporations, it may specify those dividends in respect of which it wishes to claim a deduction under section 965(a) and those dividends which it wishes to apply against the section 965(b)(2)(B) base period amount.[45] In the absence of such an election, a portion of each dividend received (or included in income under section 951(a)(1)(A)) by a U.S. shareholder is treated as deductible under section 965(a) in the same ratio that the total amount allowed as a deduction under section 965(a) bears to the total dividends (qualifying and non-qualifying) received by the U.S. shareholder during the election year.[46] By allowing taxpayers to use dividends paid out of higher-taxed earnings and profits to satisfy the base period amount distribution requirement, this rule enables taxpayers to maximize their utilization of foreign tax credits. If this general policy were extended to the section 904 context, taxpayers would have the option of affirmatively electing which types of income would be deemed used to pay the section 965 dividend in the case where a dividend is received from a controlled foreign corporation with multiple foreign tax credit pools.

An alternative, and in our view preferable, approach would be to adopt the allocation rule that currently exists in Treasury regulation section 1.904-5 with respect to dividends received from controlled foreign corporations. Under that rule, the amount of any dividend received from a particular controlled foreign corporation for which a deduction is claimed would be treated as having been made pro rata from the income pools for foreign tax

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[45] I.R.C. § 965(d)(3).

[46] Id.

credit purposes. This approach is consistent with that used for section 904 purposes generally and, for that reason, is in our view preferable to the shareholder election approach.

E. Specific Guidance Relating to Domestic Reinvestment Plans

1. General

In order to qualify for deduction under section 965(a), the amount of an otherwise qualifying dividend must be "invested in the United States pursuant to a domestic reinvestment plan".[47] The domestic reinvestment plan must provide for "the reinvestment of such dividend in the United States (other than as payment for executive compensation), including as a source for the funding of worker hiring and training, infrastructure, research and development, capital investments, or the financial stabilization of the corporation for the purposes of job retention or creation".[48] The domestic reinvestment plan must be approved by the taxpayer's president, CEO, or comparable officer before payment of the dividend and subsequently approved by the taxpayer's board of directors, management committee, executive committee, or similar body.[49]

2. Reasonable Detail and Specificity

Notice 2005-10 provides that a domestic reinvestment plan must be a written plan prepared by the taxpayer that describes the planned U.S. investment of the dividend otherwise qualifying for deduction under section 965(a) in "reasonable detail and specificity".[50] While no specific template is provided in this regard, Notice 2005-10 sets out certain general factors to be taken into account in determining whether or not the requirement is satisfied. According to Notice 2005-10, the composition of the domestic reinvestment plan may vary depending on the

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[47] I.R.C. § 965(b)(4).

[48] I.R.C. § 965(b)(4)(B).

[49] I.R.C. § 965(b)(4)(A).

[50] Notice 2005-10 at § 4.01.

type of permitted investments contemplated, the time period over which the investments will be made, and whether factors beyond the taxpayer's control could affect its ability to make the contemplated investment.[51] It must, however, describe specific anticipated investments in the United States and must provide sufficient detail to permit the electing U.S. shareholder to demonstrate that the expenditures subsequently incurred were in fact contemplated when the domestic reinvestment plan was adopted.[52] A domestic reinvestment plan that simply recites the statutory language or refers generally to permitted uses enumerated in section 965 does not, without further detail, meet the requirements of the statute.[53]

While the guidance provided in Notice 2005-10 is useful, in our view, more specific guidance is required as to when the applicable standard will be satisfied. "Reasonable detail and specificity" simply does not provide taxpayers with a meaningful standard by which to measure compliance. While we understand that it may not be feasible to establish a single template that is applicable for all taxpayers, given the importance of the requirement and the severe consequences associated with failing to satisfy it, we believe that it is appropriate to provide some specific guidelines and criteria for taxpayers to follow. One possibility in this context might be to require that a domestic reinvestment plan contain such detail as would typically be provided to a corporate officer approving an investment of the particular type in question. To the extent, however, that the Service believes that it is not feasible to provide taxpayers with more detailed, objective guidance in this regard, we believe that, at a minimum, it would be appropriate to provide taxpayers with specific examples of domestic reinvestment plans that would, and would not, meet the applicable standard.

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[51] Notice at § 4.03.

[52] Id.

[53] Id.

3. Amending a Domestic Reinvestment Plan

According to Notice 2005-10, a taxpayer is not permitted (except to implement a limited transition rule) to modify or amend a domestic reinvestment plan.[54] Notice 2005-10 provides that a taxpayer may, however, include alternative investments in a domestic reinvestment plan.[55] Such alternatives could be made where the primary investments were subsequently delayed or abandoned. The domestic reinvestment plan need not set forth the conditions under which an alternative investment will be substituted for the primary investment, but the description of such alternative investments must meet the same specificity standard applicable to the primary investments.[56]

We believe that prohibiting the amendment of a domestic reinvestment plan, particularly in a situation where one or more of the investments specified in the domestic reinvestment plan becomes impracticable or uneconomic, is punitive and that the position adopted in Notice 2005-10 should be altered to allow taxpayers to amend a plan to the extent that there is a material change in circumstances. A taxpayer should not be forced to proceed with, for example, a non-economic investment merely because the amount of any expected economic detriment from the investment is less than the costs associated with losing the section 965(a) deduction. In the absence of such a rule, taxpayers will expend needless time and effort attempting to contemplate every conceivable alternative investment (with those taxpayers that fail to anticipate the entire spectrum of future economic or commercial developments being penalized as a result). In our view, to carry out the purpose of the statute, taxpayers should be given maximum flexibility in deciding how the funds should be spent among different

[54] Notice 2005-10 at § 4.04.

[55] Notice 2005-10 at § 4.03.

[56] Id.

permissible uses. Further, the fact that transactional uses, such as acquisitions that require third-party negotiations, the outcome of which may be unpredictable, constitute permitted investments strongly argues that more flexibility in identification should be permitted.

To prevent potential abuses, a good faith limitation, such as that suggested in our December 14, 2004 letter, might be considered appropriate within the intent of the statute. The requirement could mandate that the taxpayer act in good faith in investing the funds in accordance with the domestic reinvestment plan. Further, as suggested in our prior letter, if the substitute use is substantially different in nature than the original use, re-approvals of the amended plan could be required (with re-approval by the chief executive officer being deemed to satisfy the requirement that the approval be obtained prior to the dividend).

F. Permitted vs. Non-Permitted Investments

As noted above, pursuant to section 965(b)(4), a domestic reinvestment plan must provide for the reinvestment of a qualifying dividend in the United States (other than as payment for executive compensation), including as a source for the funding of worker hiring and training, infrastructure, research and development, capital investments, or the financial stabilization of the corporation for the purposes of job retention or creation. The Conference Report confirms that the enumerated list of permissible uses is not intended to be exclusive[57] and the Joint Committee on Taxation report states that the provision is to be "construed broadly".[58] Thus, the only absolute requirement is that the funds be invested in the United States. Notice 2005-10 describes in more detail the types of investments that are permitted, and consistent with the fact that the list

[57] Conference Report at 67.

[58] J. Comm. on Tax., Description of the Chairman's Mark for the Conference Committee on H.R. 4520, October 4, 2004, Tax Analysts Doc. 2004-19594, at 134.

in section 965(b)(4) is non-exclusive, adds several permitted investments to that list. Some of the specific permitted investments are discussed in more detail below.

1. Worker Hiring, Training and Other Compensation

The first category of permitted uses listed in section 965(b)(4) relates to the use of the funds as a source of worker hiring and training. Notice 2005-10 clarifies that expenditures incurred by a taxpayer in connection with funding the hiring and training of workers, whether or not employees of the taxpayer, are permitted investments.[59] Such expenditures include not only amounts expended for the hiring of new workers and the training of new and existing workers but also any expenditures on compensation and benefits of existing and new workers.[60] Expenditures qualify only to the extent not attributable to executive compensation and only to the extent attributable to services performed within the United States, determined under the principles of Treasury regulation section 1.861-4(b)(1) in the case of services performed both within and without the United States.[61]

We note that Notice 2005-10 provides that expenditures incurred in connection with worker hiring and training may be permitted investments even if the workers are not employees of the taxpayer, provided such expenditures are borne by the taxpayer and the activities are performed in the United States.[62] In many situations, such as, for example, where services are being performed by an independent contractor, the taxpayer may have no effective way of tracking where the services are being performed. In such situations, we believe that taxpayers should be able to rely on a certification from the payee as to the location where the

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[59] Notice 2005-10 at § 5.02.

[60] Id.

[61] Id.

[62] Id.

services are performed and that, absent actual knowledge or reason to know, such certification should be conclusive of the determination.

2. Repayment of Debt

Notice 2005-10 provides that the repayment by a taxpayer of debt, regardless of whether the lender or holder is a U.S. person, is a permitted investment so long as the repayment contributes to the financial stabilization of the taxpayer for the purposes of job retention or creation in the United States.[63] According to Notice 2005-10, the repayment of debt ordinarily will be considered to contribute to the financial stabilization of the taxpayer because it improves the taxpayer's debt-equity ratio and reduces the taxpayer's obligations for debt service.[64] The requirement that financial stabilization be for the purposes of job retention or creation in the United States is satisfied if, at the time the domestic reinvestment plan is approved by the taxpayer's president, chief executive officer, or comparable official, the taxpayer's reasonable business judgment is that the resulting financial stabilization will be a positive factor in its ability to retain and create jobs in the United States.[65] An increase in the taxpayer's credit rating due to the debt repayment is not, however, required.[66]

Notice 2005-10 further provides, however, that a repayment of debt is not a permitted investment to the extent the taxpayer has, at the time of repayment, a plan or intention to incur additional debt on substantially the same terms following the date of the dividend, and the taxpayer in fact incurs such additional debt.[67] The Service's view in that case is that the

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[63] Notice at § 5.05(a).

[64] Id.

[65] Id.

[66] Id.

[67] Id.

reduction in the taxpayer's indebtedness is merely temporary and, therefore, that the repayment is not a permitted investment.[68] Pursuant to Notice 2005-10, this determination shall be made based on all of the facts and circumstances and by applying judicial doctrines, such as the substance-over-form doctrine.

While we agree with the Service's basic conclusion in this regard, we believe that the rule is cast too narrowly. In particular, we believe that where a taxpayer has a plan or intention to replace the repaid debt with new debt in the near future, such that the reduction in the taxpayer's indebtedness is merely temporary, the repayment of debt should not be viewed as contributing to the financial stabilization of the taxpayer. Instead, the taxpayer's ability to qualify for a deduction under section 965(a) should be measured by reference to the use of the proceeds from the replacement debt.

3. Tort Liabilities

Notice 2005-10 does not provide guidance with respect to whether the payment of tort liabilities qualifies as a permitted investment. As stated in our December 14, 2004 letter, it is our view that the payment of tort liabilities of a U.S. shareholder should be a permitted investment. In our view, there is little difference, at least in the section 965 context, between the payment of a tort liability and the payment of any other business related debt. Accordingly, as the latter generally would constitute a permitted investment, we believe that the payment of tort liabilities should similarly be a permitted investment. In any event, given the fact that many of the corporations that are most affected by section 965 also have significant potential product liability damages, we believe it is important that, one way or another, the Service provide definitive guidance on this point.

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[68] Id.

G. Consequences of Failing to Invest the Entire Dividend

Notice 2005-10 clarifies that if the amount of a dividend that a U.S. shareholder expends on permitted investments pursuant to a domestic reinvestment plan is less than the amount provided for in the plan, the amount of the dividend qualifies only to the extent of the amount so expended.[69] By way of illustration, Notice 2005-10 provides the following example:

> Assume a controlled foreign corporation pays a cash dividend of $100x to its U.S. shareholder pursuant to a domestic reinvestment plan that properly specifies $100x of permitted investments pursuant to [Notice 2005-10] (and the dividend otherwise qualifies for the DRD under section 965(a)), but the U.S. shareholder in fact only makes $90x of the permitted investments provided for under the plan. In such case, $10x of the $100x cash dividend does not qualify for the DRD under section 965(a); the remaining $90x qualifies for the DRD under section 965(a).[70]

Notice 2005-10 does not, however, provide any guidance as to the collateral consequences where the fact that the full amount of the dividend will not be expended on permitted investments is not determined until a subsequent year. In that situation, the taxpayer would, on the facts of the above example, obviously be required to reverse $8.5x of the 85x deduction that it claimed under section 965(a). Would, however, the taxpayer be liable for interest or penalties with respect to the $8.5x? We believe that where a taxpayer acted in good faith, it should not be penalized for failing to invest the entire dividend amount. For example, where there has been a change in circumstances, a taxpayer should not feel compelled to make an uneconomic investment merely to avoid a penalty associated with not investing the full dividend amount. In our view, provided the taxpayer acted reasonably in designating and implementing its domestic reinvestment plan, it should only be liable for the tax due with respect

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[69] Notice at § 4.07.

[70] Id.

to the dividend that was ineligible for deduction plus interest. We also believe that the understatement should be rectified by way of filing an amended return, as opposed to reversing out the deduction in a subsequent year. This would be consistent with the guidance provided in Notice 2005-10 at section 8.03 regarding tax returns filed prior to January 13, 2005.

H. Reporting and Documentation Requirements and the Safe Harbor

Pursuant to Notice 2005-10, the determination of whether a dividend has been invested in the United States pursuant to a domestic reinvestment plan generally is made under the facts and circumstances of the particular taxpayer.[71] However, Notice 2005-10 provides a safe harbor pursuant to which a taxpayer will be considered to have established to the satisfaction of the Service that the amount of the dividend has been invested in the United States pursuant to the domestic reinvestment plan as required under section 965(b)(4). To qualify for the safe harbor, the taxpayer must have expended on permitted investments (other than non-specified financial stabilization investments) at least 60 percent of the amount of the total funds to be expended pursuant to the domestic reinvestment plan by the end of the second year following the election year. For this purpose, an obligation pursuant to a binding contract or commitment entered into with unrelated persons (defined by section 267(b), other than section 267(b)(8)) to make such expenditure will be included in this calculation. Additionally, to comply with the safe harbor, the taxpayer must meet specific documentation and reporting requirements set forth in Notice 2005-10. The most significant of these requirements dictates that the taxpayer must represent that he intends to make any remaining investments pursuant to the domestic reinvestment plan (which could be as much as 40 percent) no later than the end of the fourth taxable year following the election year.

[71] Notice at § 8.01

While we believe that it is not unreasonable to rely on the intent of the taxpayer for purposes of determining whether or not a permitted investment is made within a reasonable period of time, we do not believe that the same is true with respect to the substantive requirement that the amount of the dividend actually be reinvested. Allowing taxpayers a deduction under section 965 in respect of the entire amount of a dividend in situations where as little as 60 percent of the dividend was expended on permitted investments would, in our view, be inconsistent with the intent of the statute. As noted earlier, plans frequently change and, just as we do not believe that taxpayers should be penalized merely because their circumstances change, neither do we think that it is appropriate to provide taxpayers with a windfall. Accordingly, we believe that taxpayers should ultimately be entitled to a deduction under section 965 only in respect of those amounts that are actually invested in permitted investments.