February 10, 2005

The Honorable William M. Thomas
Chairman
House Committee on Ways and Means
2208 Rayburn Office Building
Washington, DC 20515

The Honorable Charles B. Rangel
Ranking Member
House Committee on Ways and Means
2354 Rayburn Office Building
Washington, DC 20515

Re: H.R. 5395, The Tax Technical Corrections Act of 2004

Gentlemen:

I am writing on behalf of the Section of Taxation of the American Bar Association concerning the Tax Technical Corrections Act of 2004. The views expressed in this letter represent the position of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

On Friday, November 19, 2004, Chairman William M. Thomas introduced H.R. 5395, the Tax Technical Corrections Act of 2004 (“Act”), and sought comments from the public regarding needed adjustments to certain tax legislation enacted in 2004, including the American Jobs Creation Act of 2004 (“Jobs Act”). We have identified areas where adjustments are necessary to statutes created or amended by the Jobs Act and have described them here. While not an exhaustive list, we believe these areas to be among the most important requiring technical correction.

A. Code Section 965

We commend the inclusion in section 2(a)(7) of the Act of provisions addressing the section 78 gross-up problem, narrowing the scope of allocable expenses to those “directly allocable” and providing the Commissioner with authority to address potential abuses under the related party indebtedness rule. We do have additional suggestions in certain other respects, however.

1. Non-Cash Dividends for Purposes of Dividend Threshold

Under section 965 as enacted, non-cash dividends (i.e., dividends paid other than in cash) are taken into account to the same extent as cash dividends in computing the base period amount constituting the dividend threshold (“Dividend Threshold”). As proposed
to be amended by section 2(a)(7)(A) of the Act, however, dividends paid other than in cash during the election year would not count toward satisfaction of the Dividend Threshold at all. This result seems inappropriate. For consistency, we recommend that non-cash dividends be counted toward satisfying the Dividend Threshold, up to the amount of non-cash dividends taken into account in computing such threshold.

2. Treatment of PTI for Purposes of Dividend Threshold

The difference in treatment of distributions out of section 959 previously taxed income ("PTI") for purposes of establishing, on the one hand, and satisfying, on the other, the Dividend Threshold appears to create inconsistent treatment of even greater consequence.

Example. United States Shareholder “USSH” took into account during the base period a subpart F inclusion relating to controlled foreign corporation (“CFC”), and CFC did not distribute the resulting PTI during the base period. Under section 965, a subpart F inclusion is not taken into account in computing a USSH’s Dividend Threshold. To take advantage of the section 965 dividends received deduction ("DRD") with respect to distributions out of CFC’s other earnings, CFC, as per normal rules, must first distribute before or during the election year amounts that are at least equal to the PTI (which would be excluded from income) before further distributions are treated as “dividends” that may count toward satisfying the Dividend Threshold and (thereafter) qualifying for the Section 965 DRD.

Example. Assume the same facts except that CFC had distributed the PTI during the base period. USSH would be required to take into account the amount of this PTI distribution in computing its Dividend Threshold. As a result, the Dividend Threshold would increase, and a corresponding portion of distributions of other earnings in the election year would not qualify for the section 965 DRD.

The dramatically different result in the preceding examples may have resulted from Congressional attempts to measure incremental cash distributions. Nonetheless, this rationale, which supports counting distributions out of PTI during the base period for establishing the Dividend Threshold, breaks down when cash distributions out of PTI in the election year are not also counted toward satisfaction of such threshold to the extent taken into account in the base period amount. PTI treatment should be parallel in both parts of the calculation to the extent of PTI taken into account in establishing the Dividend Threshold.

We recommend that an amendment be added to the Act, to the effect that distributions out of PTI are taken into account in satisfying the Dividend Threshold to the same extent distributions out of PTI were actually taken into account in establishing such threshold.
3. **Treatment of Spinoff Transactions on Base Period Amount**

Section 965(c)(2)(C)(ii) sets forth special rules for section 355 distributions during the base period if the controlled (distributed) company is a USSH of a CFC. In such case, first, the controlled USSH is treated as being in existence during the period that the distributing corporation is in existence, and hence would have the same five-year history for purposes of determining the base period as the distributing corporation (even if the controlled USSH is newly formed in a “D” reorganization). Second, for purposes of determining the Dividend Threshold, amounts potentially includible in such threshold (i.e., described in section 965(b)(2)(B)) received or includible by either the distributing corporation or the controlled USSH before the section 355 distribution are to be allocated between such corporations “in proportion to their respective interests as [USSHs] of such [CFC] immediately after such distribution” (i.e., generally to the controlled USSH). Such apportionment of the pre-distribution base period amount based on post-transaction ownership seems to be a reasonable approach, and generally (subject to, e.g., shifts of debt) aligned with the ability to repatriate funds from the CFC. We are unclear, however, why a special rule for spinoff transactions (as opposed to other transactions) is necessary, and why it is confined to distributions qualifying under section 355 and only those made during the five-year period taken into account in determining the base period. We believe the Act should include a provision that requires adjustments to be made in the event of a distribution of shares of a corporation meeting a certain ownership threshold occurring at any time on or after the first day of the first taxable year taken into account in determining the base period and regardless of whether it meets the requirements of section 355.

4. **Taxes Shown on Applicable Financial Statement**

With respect to the case in which the U.S. tax liability rather than the underlying permanently reinvested income is shown on the applicable financial statement, section 965(b)(1)(C) provides that the tax liability should be divided by 0.35 to derive the corresponding income amount. This calculation, however, yields an understated result, as the U.S. tax liability shown generally reflects the fact that the income was subject to foreign tax for which a credit would be allowed, and so only includes the incremental U.S. tax liability. Accordingly, dividing by 0.35 may substantially understate the corresponding income.

The impact of this provision was quickly discovered and made the subject of a colloquy involving Senators Grassley and Santorum. In response to Senator Santorum’s colloquy, Finance Committee Chairman Grassley noted that it was “a very good point that Congress should revisit in the future” and encouraged Treasury to consider issuing guidance that permits taxpayers to more accurately reflect the actual amount of earnings permanently invested offshore.

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.

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We believe, however, that reference made for the limited purpose of determining the amount of underlying tax should be permitted in the interest of fairness. Accordingly, we believe the Act should permit taxpayers to increase the amount of U.S. tax liability shown in financial statements, for purposes of computing the ceiling on qualifying dividends, by the amount of the U.S. foreign tax credit reflected in computing such U.S. tax liability.

5. Related party indebtedness

We recommend that the Act permit taxpayers to elect to use a September 30, 2004, rather than an October 3, 2004, testing date for related party indebtedness in order to comport with the realities of bookkeeping and public accounting.

We recommend that the Act require that a single currency translation rate be used for the two testing points for related party indebtedness. Otherwise, the comparison would be fundamentally inconsistent.

We also recommend that Treasury be granted regulatory authority to deal with various other issues under the related party indebtedness rules. For example, in the case of an acquisition of a U.S. corporation or group during the period after October 3, 2004 through the end of the election year, it would be appropriate to take account of related party indebtedness, if any, existing between such target corporation or group and its CFCs. Further, such regulatory authority could provide that the “amount” of related party indebtedness not be based simply upon indebtedness existing at specific moments in time but rather adjusted for seasonal levels of related party indebtedness. As a third example, such authority also could permit Treasury to provide exceptions from the definition of related party indebtedness for indebtedness that arises in certain ordinary business transactions between a CFC and related persons. Such exceptions would be desirable not just to address seasonal differences or growth of the business but also to lessen the burden of compliance.

6. Cash versus cash equivalents

Treasury and IRS apparently do not believe that they have authority to construe the requirement for a “cash” distribution to include a distribution of short-term deposits. As a result, many taxpayers would be required to incur breakage costs. We recommend that under the Act or pursuant to a grant of regulatory authority, taxpayers be permitted to distribute short-term time deposits in satisfaction of section 965’s cash distribution requirement, particularly since cash distributed could simply be reinvested in such short-term investments by the recipient USSH. For example, if a CFC holds a 180-day certificate of deposit with a bank, it would seem appropriate to allow that CFC to distribute the certificate of deposit to the USSH without the need to first convert it to cash and incur breakage costs.

7. Foreign tax credit implications

Certain section 78 gross-up issues and section 904 sourcing issues can arise in respect of the nondeductible dividend. One approach that may neatly deal with these issues would be to provide for separate limitation category (basket) treatment for the nondeductible
portion of qualifying dividends in the election year. This separate basket would be temporary and would alleviate issues that may otherwise result when calculating the amount of foreign tax credit that may be applied against the 15% nondeductible portion of the section 965(a) eligible dividend. We believe that the Act either should adopt such an approach or provide Treasury with regulatory authority to do so.

B. Code Section 7874

As enacted, section 7874 can apply to a domestic entity regardless of whether it has any U.S. owners. For example, if foreign entities operate through a domestic corporation, LLC, partnership or trust and wish to convert the entity into a foreign entity or transfer their interests in the domestic entity to a foreign entity, the expatriation regime could apply unless the “substantial business activities” test is met.

In fact, the domestic entity in question might have no U.S. business assets. In the starkest case, the entity could be a domestic pass-through entity holding only passive assets or foreign business assets and wholly owned by foreign persons. Under section 7874, a transfer of the entity’s assets or of the interests in the entity to a foreign corporation could result in treatment of the transferee foreign corporation as a domestic corporation.

A provision intended to protect certain group restructurings provides for disregarding stock held by a member of the expanded affiliated group. Unfortunately, under this provision, even a single share held before and after by a non-member of the group can cause domestication.

1. Partnership Trade or Business

As noted, section 7874 as enacted can apply in respect of a partnership (as well as a corporation) even though the entity’s trade or business in question does not generate income effectively connected with a U.S. trade or business. We can discern no policy reason for treating a foreign corporation acquiring such a trade or business as a domestic corporation simply because the business had been operated through a domestic partnership. We recommend that the Act clarify that the trade or business of the domestic partnership be one that, if it were held by a foreign partner, would give rise to, at least to a substantial extent, income effectively connected with the conduct of a U.S. trade or business.

2. Threshold Percent of Former U.S. Owners

As noted, section 7874 as enacted can apply even though most or even all of the owners of the domestic entity are non-U.S. This scope can cause clearly unintended transactions to be covered. This would be the case even if our first recommendation is adopted.

For example, if three equal and unrelated non-U.S. owners of a domestic enterprise each transfer their interests to a foreign corporation formed in a jurisdiction in which the substantial business activities test is not met, the group restructuring exception, which requires an expanded affiliated group, would not be applicable and the acquiring corporation would be treated as domestic. Similarly, if a foreign individual transfers all of the shares of
a domestic corporation to a foreign corporation (for example, in order to avoid holding a U.S.-situs asset for U.S. estate tax purposes), the transferee foreign corporation would be treated as domestic unless the substantial business activities test were met. We believe that these results are unintended and recommend that section 7874 not apply to a transaction unless at least a certain minimum percent (e.g. 35%) of the owners of the expatriating domestic entity are U.S. persons.

3. Disregard of Stock Held by Expanded Affiliated Group

Where the transferee foreign corporation is a member of an expanded affiliated group, unintended inversions could be avoided by clarifying that, for purposes of the rule disregarding stock held by members of the expanded affiliated group, stock in the foreign acquiring entity will be disregarded only in the numerator and not the denominator in determining the percentage ownership of former shareholders in the foreign acquiring entity. As noted above, unintended inversions may result where, for example, there is more than one owner of a domestic entity, the entity is transferred to a foreign corporation formed in a jurisdiction in which there are not substantial business activities, and the foreign corporation is a member of an expanded affiliated group but one or more of the former shareholders is not.

4. Regulatory Authority

Currently, Section 7874 provides only limited regulatory authority. Section 7874(g) states that “[t]he Secretary shall provide such regulations as are necessary to carry out this section, including regulations providing for such adjustments to the application of this section as are necessary to prevent the avoidance of the purposes of this section, including the avoidance of such purposes through -- (1) the use of related persons, pass-through or other non-corporate entities, or other intermediaries, or (2) transactions designed to have persons cease to be (or not become) members of expanded affiliated groups or related persons.” The legislation apparently does not provide Treasury the authority to provide exceptions, even in cases where the legislation clearly was not intended to apply. Such cases could include situations not covered by the exceptions recommended above.

We recommend that Treasury be granted regulatory authority to provide exceptions to the section 7874 rules, particularly since they apply retroactively to transactions completed after March 4, 2003. This type of grant of authority has been provided in similar cases. Compare, e.g., section 367(a)(6). Accordingly, we recommend that the Act grant Treasury appropriate regulatory authority, including to provide exceptions to the application of section 7874.

C. Apportionment of Interest Expense

Section 864(f)(5) provides an election to expand the financial group for purposes of the new worldwide method of allocating and apportioning interest expense. The election applies if the taxpayer elects the application of this “subsection.” We recommend that the term “subsection” be replaced by the term “paragraph.” Absent such change, the election to
expand the financial group would be automatic upon election of the worldwide method under the subsection.

D. US Branch Profits Tax Rate for Puerto Rican Company

Puerto Rico is not part of the “United States” as defined in section 7701(a)(9). Accordingly, Puerto Rico is treated for U.S. withholding tax purposes as foreign. As there is no income tax treaty between the United States and Puerto Rico, withholding generally is at the 30% statutory rate.

Section 420 of the Jobs Act reduces the rate of withholding tax on dividends paid to Puerto Rico from 30% to 10%. The purpose of the change is to provide reciprocity with the Puerto Rico dividend withholding tax rate, which is generally imposed at a rate of 10% (though a lower rate often is available under certain incentive regimes). If the applicable Puerto Rican dividend withholding tax rate increases above 10% in the future, then the U.S. rate will revert to 30%.

We believe that the 10% rate should be applicable for purposes of the section 884(a) branch profits tax (“BPT”) as well. The BPT is a tax that is designed to mirror the dividend tax in situations in which a foreign corporation operates through a branch in the United States. Puerto Rico imposes a BPT but, as with the dividend withholding tax, the rate is only 10%. Moreover, no Puerto Rico BPT is imposed on income covered by a tax grant or in circumstances where more than 80% of taxable income of the entity is from Puerto Rico sources. Accordingly, we recommend that the Act provide for a 10% BPT rate, to be applicable for the same period as the 10% dividend withholding tax rate.

We appreciate your consideration of these comments. Representatives of the Section would be pleased to discuss them in further detail with you or members of your respective staffs. Please contact Stuart Lewis, the Section’s Vice-Chair for Government Relations, at (202) 452-7933 if that would be helpful.

Sincerely,

Kenneth W. Gideon
Chair, Section of Taxation

cc: Hon. John Snow, Secretary of the Treasury
    Eric Solomon, Acting Deputy Assistant Secretary of the Treasury (Tax Policy)
    George Yin, Chief of Staff, Joint Committee on Taxation
    Robert Winters, Republican Chief Tax Counsel, House Ways and Means Committee
    John Buckley, Democratic Chief Tax Counsel, House Ways and Means Committee
    Kolan Davis, Republican Staff Director and Chief Counsel, Senate Finance Committee
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