April 19, 2005

Eric Solomon
Acting Deputy Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3104 MT
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Mark W. Everson
Commissioner of Internal Revenue
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, NW
Washington, DC  20224

Re: Requests for Guidance Concerning Temporary Dividends Received Deduction for Reinvestment of Foreign Earnings in the United States (Section 965 of the Internal Revenue Code).

Dear Gentlemen:

Enclosed are comments requesting guidance concerning the temporary dividends received deduction for reinvestment of foreign earnings in the United States. These comments represent the individual views of those members who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

Sincerely,

Kenneth W. Gideon
Chair, Section of Taxation

Enclosure
REQUESTS FOR GUIDANCE CONCERNING
TEMPORARY DIVIDENDS RECEIVED DEDUCTION FOR REINVESTMENT OF
FOREIGN EARNINGS IN THE UNITED STATES
(SECTION 965 OF THE INTERNAL REVENUE CODE)

The following comments and requests for guidance were prepared by individual members of the Foreign Activities of U.S. Taxpayers Committee (FAUST) of the Section of Taxation of the American Bar Association. These comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

Substantial contributions in respect of these comments were made by Peter Blessing, Paul Crispino, Tim Devetski, Michael DiFronzo, Mark Harris, John Hynes, Rebecca Rosenberg, Carol Tello and Lowell Yoder. Additional comments were received from Philip West. The comments were reviewed by Nicholas Freud of the Section of Taxation’s Committee on Government Submissions and by N. Susan Stone, Council Director for FAUST.

Although many of the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal tax principles addressed herein or have advised clients on the application of such principles, with two exceptions no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a governmental submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments. The two exceptions concern firms that were engaged with respect to specific areas of section 965, and the contributors from those firms have not written or commented on the areas with respect to which their firms were engaged.

Contact Person: Tim Devetski
tdevetski@velaw.com
713-758-2975

April 19, 2005
I. Executive Summary

These comments address the temporary dividends received deduction (“DRD”) under section 965 of the Internal Revenue Code and include requests for administrative guidance thereunder.

Section 965 of the Internal Revenue Code provides a domestic corporation that is a United States shareholder (“USSH”) of a controlled foreign corporation (“CFC”) with a temporary election to deduct 85% of cash dividends received from CFCs during the domestic corporation’s last taxable year beginning before, or first taxable year beginning after, October 22, 2004 (the date of enactment of section 965).

Part III of these comments provides suggestions for administrative guidance and technical legislative corrections regarding (i) the base period threshold that a taxpayer must satisfy with certain repatriations before further repatriations may qualify for the benefits of section 965 and (ii) the maximum deductible dividends that a taxpayer may claim under section 965. In each case, these comments conclude that adjustments should be made to such threshold and maximum deductible amounts upon certain extraordinary transactions, such as mergers and acquisitions, and provides specific suggestions for making such adjustments.

Part IV provides comments on issues relating to funding qualifying repatriations under section 965, including related party borrowing, payment of qualifying repatriations in “cash” and a proposed technical correction providing the Treasury Department with additional authority to address such issues. In general, these comments recommend providing explicit guidance illustrating indirect funding in the context of otherwise qualifying repatriations.

Part V addresses domestic reinvestment plan (“DRIP”) drafting issues, and Part VI discusses issues relating to qualified uses for repatriated funds. While each of these topics generally has been covered in detail in recent administrative guidance, we provide discussion of them here in order to address certain remaining issues.

Part VII of these comments discusses the nondeductibility of expenses allocated and apportioned to dividends qualifying for the deduction under section 965, and addresses the proposed technical correction in this regard. The comments conclude that in light of the commitment of the chairmen of the relevant tax-writing committees of Congress to introduce technical corrections to carry out the intention of the statute, Treasury and the IRS should consider providing immediately effective guidance consistent with this proposed technical correction.

Finally, Part VIII of these comments discusses certain foreign tax credit issues that we believe deserve attention, including immediate implementation of the proposed technical correction.

1 Unless otherwise indicated, all references to “section” or “§” are to the Internal Revenue Code of 1986, as amended (the “Code”).
II. Introduction and Background

There are a number of technical requirements that must be satisfied in order for a USSH to be entitled to the section 965 DRD with respect to a dividend received from a CFC. First, the amount received generally must be a “dividend” for federal income tax purposes and must be received in “cash.” In addition, the dividend received must be “extraordinary” in the sense that it exceeds dividends received by the USSH from CFCs during a given “Base Period.” There is also an upper-limit on the section 965 DRD (the “Ceiling Limitation”), pursuant to which the section 965 DRD is only available with respect to dividends received to the extent of the greater of $500 million or the amount reported by the USSH on financial statements as permanently reinvested outside the United States pursuant to Accounting Principles Board Opinion No. 23 (“APB 23”). The year for which the USSH elects to apply the section 965 DRD is referred to herein as the “Election Year.”

In addition to these technical requirements and limitations, in order to qualify for the section 965 DRD, the cash dividend received by the USSH must be invested in the United States pursuant to a “domestic reinvestment plan” (“DRIP”). A DRIP generally may provide for the reinvestment of the dividends received in (among other uses) “worker hiring and training, infrastructure, research and development, capital investments, or the financial stabilization of the [USSH] for the purposes of job retention or creation.” As discussed in detail below, on January 13, 2005, the Treasury Department published Notice 2005-10, which provides guidance inter alia regarding DRIPs and the permitted uses of a dividend qualifying for the section 965 DRD.

Notwithstanding this very helpful recent guidance, there remains a great deal of uncertainty regarding qualification for the section 965 DRD. This uncertainty raises significant concerns both within tax departments of U.S. multinational corporations and with these corporations’ financial statement auditors. If a corporation fails to satisfy the section 965 requirements, the tax charge associated with repatriating foreign earnings generally rises from the reduced tax rate of 5.25% to the normal 35%. Thus, the stakes are high.

To address certain concerns under section 965, members of Congress introduced a technical corrections bill (“Technical Corrections Bill”) in the last congressional session. The

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2 There are certain limited technical exceptions to the requirement that only “dividends” received in cash will qualify (e.g., up-the-chain dividends from lower-tier subsidiaries in the Election Year; liquidating distributions that give rise to an “all earnings and profits” inclusion). Because these technical exceptions also require that cash be paid (and its receipt treated as a dividend) in the Election Year, we generally indicate in the text that only cash dividends from a CFC will qualify for the section 965 DRD.


4 See generally, http://www.fasb.org/fasb_staff_positions/fsp_fas109-2.pdf. The Financial Accounting Standards Board (“FASB”) has recognized the uncertainty surrounding section 965’s repatriation incentive and has drafted an exception to FAS 109 that allows a company to postpone booking a tax charge until it has completed its evaluation of the repatriation incentive. A copy of the December 21, 2004 FASB Staff Position (FSP FAS 109-2) is posted at the above-mentioned website.

introducing members explicitly requested comments on the provisions of the Technical
Corrections Bill and indicated that a revised version of the Technical Corrections Bill would be
introduced in the present session. In response to this request, and the separate request of the
Treasury Department and the Internal Revenue Service for comments on issues arising under
section 965, we provide the following comments and suggestions for guidance. In light of the
short window for planning and implementing repatriations that qualify for the section 965 DRD,
we commend the Treasury Department’s announced commitment to publishing guidance in the
near term on these issues.

III. Calculating the Maximum Deductible Dividend

1. Base Period Dividend Threshold

   a. Background

   Section 965(b)(2) establishes an “extraordinary dividend” requirement for eligible
dividends. Such requirement takes the form of a dividend threshold (the “Dividend Threshold”)
that must be satisfied before further dividends may qualify for the section 965 DRD. Under the
Technical Corrections Bill, the Dividend Threshold must be satisfied by dividends paid in
“cash,” thus conforming the dividends that satisfy the Dividend Threshold with dividends that
qualify for the section 965 DRD. For purposes of computing the Dividend Threshold, and
determining when it has been satisfied, all CFCs in respect of a given USSH are grouped
together.

   The Dividend Threshold with respect to a given USSH is determined under section
965(b)(2)(B) by taking the annual average for a “Base Period” of the sum of the following three
items:

   • Cash and non-cash dividends received by the USSH from a CFC.

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receive comments on the technical corrections bill. The technical corrections provisions in today’s introduced
bill, along with any modifications or additions, will then be introduced in the 109th Congress.”); see also Letter
from William M. Thomas, Chairman, House Ways & Means Committee, Charles E. Grassley, Chairman,
Senate Finance Committee and Max Baucus, Ranking Member, Senate Finance Committee, to Eric Solomon,
Acting Deputy Assistant Secretary for Tax Policy, Treasury Department (March 17, 2005) (affirming that a
technical corrections bill will be introduced in the 109th Congress).

7 The Section of Taxation, including the FAUST Committee, has submitted separate comments specifically
addressing aspects of the Technical Corrections Bill. See note 13 below.

38-3 (Feb. 28, 2005) (reporting comments of Hal Hicks, IRS Associate Chief Counsel (International)).

9 See I.R.C. § 965(b)(2)(A) (“dividends received . . . by such shareholder from controlled foreign corporations”),
(b)(2)(B)(i) (“dividends received . . . by such shareholder from controlled foreign corporations”), (b)(2)(B)(ii)
(“amounts includible in . . . income . . . under section 951(a)(1)(B) with respect to controlled foreign
corporations”), (b)(2)(B)(iii) (“amounts that would have been included . . . but for section 959(a) with respect to
controlled foreign corporations”).
• Amounts included in income of the USSH under section 951(a)(1)(B) by reason of CFC investments in United States property under section 956.

• Amounts received by the USSH from CFCs out of previously taxed earnings (i.e., that are excluded from the USSH’s income under section 959(a), whether attributable to up-the-chain distributions within the Base Period or to other subpart F inclusions within or outside of the Base Period), but not including amounts received out of previously taxed earnings resulting from prior year section 951(a)(1)(B) inclusions.\textsuperscript{10}

The “Base Period” generally includes three taxable years of the USSH. The relevant three years are selected from the five most recent taxable years of the USSH ending on or before June 30, 2003, by disregarding the highest and the lowest years (i.e., disregarding the taxable years during such five-year period for which the sum of the three components of the Dividend Threshold is the highest and the lowest). Although the remaining three taxable years generally constitute the Base Period (for which the average annual sum of the three components set forth above will equal the Dividend Threshold), if the USSH has completed fewer than five taxable years on or before June 30, 2003, then the Base Period includes all the USSH’s taxable years ending on or before June 30, 2003.\textsuperscript{11}

b. Items Counted Toward Establishing But Not Toward Satisfying the Dividend Threshold

i. General

As previously stated, dividends qualifying for the section 965 DRD (and under the Technical Corrections Bill, dividends that count toward satisfaction of the Dividend Threshold) include only dividends paid in cash. Nonetheless, the following additional amounts are taken into account in the same manner and extent as cash dividends in computing the Dividend Threshold:

• Non-cash dividends.

• Section 951(a)(1)(B) inclusions.

• Distributions of previously taxed earnings excludible from income under section 959(a) other than amounts paid out of previously taxed earnings relating to a section 951(a)(1)(B) inclusion.

We comment on the first and third of these items below.

\textsuperscript{10} Although not entirely clear, the drafters of section 965 may have considered section 951(a)(1)(B) inclusions themselves to constitute repatriations. Consequently, as described in the previous bulleted item, section 951(a)(1)(B) inclusions during the Base Period are separately counted toward the Base Period Amount, but other section 951(a)(1)(B) inclusions (i.e., occurring other than during the Base Period) and distributions out of previously taxed earnings attributable to such section 951(a)(1)(B) inclusions are disregarded.

\textsuperscript{11} In light of this provision, we believe that a relatively new USSH that has no taxable years ending on or before June 30, 2003, would have a zero Dividend Threshold. We recommend that this conclusion be confirmed.
ii. Non Cash Dividends

Non-cash dividends (i.e., dividends paid other than in cash)\textsuperscript{12} are taken into account to the same extent as cash dividends in computing the Dividend Threshold but, as a result of an amendment proposed to be made by the Technical Corrections Bill, dividends paid other than in cash during the Election Year would not count toward satisfaction of the Dividend Threshold. This result seems to us 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.

iii. PTI Distributions During Base Period Versus During Election Year

The difference in treatment of distributions out of previously taxed earnings (“PTI”) for purposes of establishing and satisfying the Dividend Threshold under the Technical Corrections Bill also is puzzling and is of broader concern.

Example. Assume USSH owns CFC (and no other foreign corporations). At some time in the past, USSH took into account a $100 subpart F inclusion relating to CFC, and CFC did not distribute the resulting PTI. CFC has $900 of other (non subpart F) earnings and profits.

Under section 965, a subpart F inclusion is not taken into account in computing USSH’s Dividend Threshold; thus, assuming CFC made no distributions during the Base Period, USSH’s Dividend Threshold generally would be zero. To take advantage of the section 965 DRD with respect to distributions out of CFC’s other earnings, however, CFC must first distribute amounts that are at least equal to the $100 of PTI. Once CFC has distributed such $100 (which would be excluded from USSH’s income under section 959), further distributions may be treated as “dividends” that may qualify for the section 965 DRD. Under such circumstances, a dividend distribution of the full $900 of CFC’s other earnings and profits may qualify for the section 965 DRD.

Example. Assume the same facts as above except that CFC had distributed the $100 of PTI during the Base Period. In such case, USSH would be required to take into account the amount of this PTI distribution in computing its Dividend Threshold. As a result, USSH’s Dividend Threshold would be $100/3 or $33. Now, a dividend distribution of the full $900 of CFC’s earnings and profits will only qualify in part for the section 965 DRD—the first $33 of such dividend will satisfy the Dividend Threshold (and thus will be subject to tax at a maximum rate of 35%), and the remaining $867 of such dividend may qualify for the section 965 DRD. In effect, the distribution of PTI during the Base Period (instead of after or

\textsuperscript{12} Such dividends could include, e.g., dividends in kind, dividends resulting from a debt assumption and constructive dividends not involving a cash repatriation. Amounts treated as dividends under sections 367(b) (other than cash distributions pursuant to the liquidation of a CFC) or 1248, as well as amounts includible under section 78, are not “dividends” for the purposes of section 965(c)(3) and thus are not counted in determining the Dividend Threshold. See I.R.C. § 965(c)(3)
before the Base Period) will result in the disqualification of a portion of cash dividends paid during the Election Year from the section 965 DRD.

The dramatically different result in the preceding examples may have resulted from an attempt to measure incremental cash distributions. Nonetheless, this rationale, which supports counting distributions out of PTI during the Base Period toward 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. We believe the treatment of PTI should be parallel in both parts of the calculation, such that to the extent PTI distributions are actually taken into account in establishing the Dividend Threshold, the same amount of PTI distributions should be taken into account in determining when the Dividend Threshold has been satisfied.

We recognize that this inconsistent treatment and inequitable result is rooted in the statute and, therefore, a change would require a statutory amendment. We also recognize that the Technical Corrections Bill currently would clarify that only cash dividends paid during the Election Year may be counted toward satisfaction of the Dividend Threshold. Nonetheless, we believe that the Technical Corrections Bill should be changed and an amendment added thereto, 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.13

iv. Effect of Audit Adjustments

The Dividend Threshold generally is determined on the basis of amounts set forth on the USSH’s federal income tax return filed for each of the five taxable years ending on or prior to June 30, 2003. If an amended return has been filed, the most recent return is the relevant return, except that an amended return filed after June 30, 2003 is not taken into account.14 The statute makes no mention of the treatment of adjustments resulting from an examination by the Internal Revenue Service.

The June 30, 2003 cut-off date after which changes in tax returns will not affect the Dividend Threshold may have been designed to conform to the cut-off date for the financial statements taken into account in computing the Ceiling Limitation. This date also may have been selected as a date after which taxpayers may have begun to arrange their affairs to take into account the potential availability of the section 965 DRD,15 although we note that this is not a cut off date for original returns filed for taxable years ending on or prior to June 30, 2003 and the original return for a domestic corporation’s last taxable year ending on or prior to June 30, 2003 may not have been due on or prior to such date.

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14 I.R.C. § 965(b)(2).

15 Chairman Thomas introduced H.R. 2896, which contained an earlier version of section 965, in the House of Representatives on July 25, 2003.
While arguments may be made for taking into account all agreed tax audit adjustments in computing the Dividend Threshold, we see no reason to treat tax audit adjustments agreed by the Internal Revenue Service or otherwise final on or prior to June 30, 2003 any differently from amended returns filed on or prior to such date for purposes of computing the Dividend Threshold.

2. Extraordinary Transactions Resulting in Adjustments to Dividend Threshold

Section 965(c)(2)(C) sets forth rules addressing the effect of certain extraordinary transactions, such as acquisitions, dispositions and spinoffs.

a. Acquisitions and Dispositions

i. Background

With respect to acquisitions and dispositions (including by merger), section 965(c)(2)(C)(i) states that rules “similar to the rules of subparagraphs (A) and (B) of section 41(f)(3)” apply for purposes of the Base Period (which presumably means for purposes of determining the Dividend Threshold). In addition, the Conference Committee description of section 965 (the “Conference Report”) indicates that in situations “involving companies entering and exiting corporate groups, the principles of Code section 41(f)(3)(A) and (B) apply.”

The section 41(f)(3) rules deal with the effect of acquisitions and dispositions on the computation of a base amount for the section 41 credit for increasing research expenditures by members of a controlled group. Under section 41(f)(3)(A), if a taxpayer acquires “the major portion of a trade or business of another person” (referred to as a “predecessor”) or “the major portion of a separate unit of a trade or business of a predecessor,” then, for purposes of calculating the base amount for any taxable year ending after the acquisition, the amount of the acquirer’s qualified research expenses and gross receipts for preacquisition periods must be increased by so much of the predecessor’s qualified research expenses and gross receipts as are “attributable” to the portion of the trade or business or separate unit acquired. The determination of “the major portion” of assets takes into account relative fair market values, goodwill, number

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16 Section 965(c)(2)(C)(i) states, “Rules similar to the rules of subparagraphs (A) and (B) of section 41(f)(3) shall apply for purposes of this paragraph.” (Emphasis added.) Consequently, the section 41(f)(3) rules literally apply only for purposes of section 965(c)(2), which defines the relevant base period years but otherwise contains no operative provisions. Reading the provision so narrowly, however, and not also for purposes of the related operative provision (i.e., the computation of the Dividend Threshold) would produce nonsensical results. We note that the version of section 965 introduced in the Senate following House passage, but not enacted, would have clearly provided this approach. It stated, “For purposes of this section . . . Rules similar to the rules of section 41(f)(3) shall apply in the case of acquisitions or dispositions of controlled foreign corporations occurring on or after the first day of the earliest taxable year taken into account in determining the fixed base period.” See H.R. 4520 as introduced in the Senate (proposing new section 965(c)(5)). (Emphasis added.) Compare I.R.C. § 936(j)(5)(D) (“Rules similar to the rules of subparagraphs (A) and (B) of section 41(f)(3) shall apply for purposes of this subsection.”) (Emphasis added.) The difference in language may be merely attributable to the fact that the starting point for the final legislation was the House version, which contained the language set forth above and in the text. See H.R. Rep. 108-755, at 67 (2004). In any event, we believe that section 965(c)(2)(C)(i) should apply for purposes of computing the Dividend Threshold.

of employees, and sales and income of the transferred business as compared with the remaining assets. A “separate unit” is a segment of a trade or business capable of operating on its own with minor adjustments.\(^\text{18}\)

Section 41(f)(3)(B) sets forth a parallel rule for dispositions of the major portion of a trade or business or separate unit of a trade or business, whereby the disposing party is permitted to decrease its base amount, but only if the disposition occurs in a transaction to which section 41(f)(3)(A) applies to the acquirer and if the disposing party furnishes the acquirer certain information necessary to permit the acquirer to apply section 41(f)(3)(A) with respect to its acquisition. For purposes of section 41(f)(3)(A), an “acquisition” includes an incorporation or liquidation.\(^\text{19}\) Whether the transaction is taxable or tax-free, a stock deal or asset deal, however, is irrelevant. Further, acquisitions and dispositions within the controlled group are disregarded.

Applying section 41(f)(3) principles in the present context, we believe that adjustments might properly be made to a taxpayer’s Dividend Threshold upon the following acquisition or disposition events:

- A threshold percentage of equity interests in a CFC is disposed of by a USSH outside of the USSH’s consolidated group.\(^\text{20}\)
- A threshold percentage of equity interests in a CFC is acquired from outside the acquirer’s consolidated group by a domestic corporation that is or becomes a USSH with respect to such CFC.
- A domestic corporation that is a USSH of a CFC (and would be a USSH of such CFC on a stand-alone basis, e.g., without regard to its constructive ownership of stock owned by corporations not directly or indirectly owned by such domestic corporation), becomes a member or ceases to be a member of a consolidated group.\(^\text{21}\)

\(^{18}\) Treas. Reg. §§ 1.52-2(b)(3), 1.52-2(b)(2)(i).

\(^{19}\) An acquisition also may include a lease agreement if the effect is to transfer the major portion of a trade or business or a separate unit of a trade or business for the period of the lease. Treas. Reg. §§ 1.41-7(b), 1.52-2(b)(1). A transfer of physical assets alone is insufficient to constitute a transfer of a “trade or business”; a viable trade or business must be transferred. Id. § 1.52-2(b)(1)(ii).

\(^{20}\) We note that a single Dividend Threshold is computed for an affiliated group of corporations filing a consolidated federal income tax return (i.e., a “consolidated group”). I.R.C. § 965(c)(5)(A).

\(^{21}\) Because a single Dividend Threshold is computed for an affiliated group of corporations filing a consolidated federal income tax return (i.e., a “consolidated group”), we believe the entry or departure of a domestic corporation from the consolidated group constitutes an appropriate time to adjust the group’s (and the separate corporation’s) Dividend Threshold. See H.R. Conf. Rep. No. 108-755, at 302 n.110 (2004) (“in cases involving companies entering and exiting corporate groups, the principles of Code section 41(f)(3)(A) and (B) apply.”). This approach appears to be consistent with the rules under section 41(f)(3). See I.R.C. § 41(f)(1) (treating all members of a controlled group as a single taxpayer for purposes of computing the research credit, and then apportioning the credit so determined among the members of such group); ILM 200234063 (May 24, 2002) (acquisition of a corporation from outside the acquirer’s controlled group resulted in adjustments under section 41(f)(3)); FSA 200227013 (March 22, 2002) (spin off of a pre-existing subsidiary corporation resulted in adjustments under section 41(f)(3)).
In general, we believe that when an adjustment event occurs, the Dividend Threshold of the acquiring USSH should be determined by taking into account distributions actually paid by the acquired CFC (i.e., received by a predecessor USSH) or received by the acquired USSH (with respect to an acquisition of a USSH), as if the acquirer actually owned the stock of the CFC or the USSH at the time of such distributions.\(^\text{22}\) Similarly, we believe that the Dividend Threshold of a disposing USSH or consolidated group disposing of a USSH should be determined by ignoring distributions received from the disposed CFC or received by the disposed USSH, as if the disposing person or group did not actually own the CFC or USSH at the time of such distributions.\(^\text{23}\) As discussed below, however, special rules may be required for acquisitions or dispositions occurring during an Election Year.

ii. Application to Section 965 Dividend Threshold to Changes in Ownership of Interests in CFCs

As noted above, section 965(e)(2)(C)(i) indicates that rules “similar” to those under section 41(f) are applicable for purposes of computing the Dividend Threshold.\(^\text{24}\) The concern addressed by section 41(f)(3) is that a taxpayer that historically incurred limited research expenditures may obtain the benefit of a research credit by acquiring a business that regularly incurs substantial research expenditures. In the event there were no increase in research expenditures with respect to the acquired business, the acquirer may obtain the benefit of a credit despite the fact that the person disposing of the business would not have been entitled to one.\(^\text{25}\)

Section 965 DRD is intended to increase repatriations from CFCs to USSHs. To the extent a USSH that historically received limited distributions from CFCs acquired a CFC that regularly distributed funds to a USSH, it may be argued that without rules similar to section 41(f)(3), the acquiring USSH may obtain the benefit of a section 965 DRD with respect to dividends from the CFC during the Election Year despite the fact that the disposing USSH would not have been entitled to such benefit under similar circumstances. Thus, it may be argued that the acquiring USSH should be required to take into account the CFC’s dividend paying history in computing its Dividend Threshold.

Arguments also have been made, however, in support of the position that an acquiring USSH should not be required to take into account the dividend paying history of a CFC it

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\(^\text{22}\) Cf. ILM 200234063 (May 24, 2002) (the acquirer’s research expenditures for its taxable year were computed by taking into account research expenditures actually made by the acquired corporation prior to the acquisition).

\(^\text{23}\) Thus, we generally do not believe that differences in the taxable years of the acquired or acquiring corporations should have relevance. Cf. ILM 200234063 (acquirer and acquired corporations maintained different taxable years; the acquirer took into account expenditures actually made by the acquired corporation during the acquiring corporation’s taxable year, even though the acquired corporation was not a member of the acquiring corporation’s consolidated group during such period).

\(^\text{24}\) See note 16 supra.

acquires, but rather, section 41(f)(3) principles should be applied only with respect to the
acquisition or disposition of a USSH.  

For example, it is noted that when the Conference Committee added a special rule to section 965 providing for allocations of the Dividend Threshold upon a spin off of a USSH (described below), they did not provide a similar rule for spin offs of CFCs. As set forth above, the Conference Report describes the spin off rule and then indicates that section 41(f)(3) principles would have application “in other cases involving companies entering and exiting corporate groups.” There is no other discussion of the application of section 41(f)(3) principles in the Conference Report, and thus one might draw the inference that such principles apply only in the context of changes in ownership of a USSH.

Moreover, as described below, a disposing USSH’s section 1248 dividend may give rise to PTI in the hands of the acquiring USSH, and thus effectively reduce the acquirer’s ability to receive “dividends” from the acquired CFC that may satisfy the Dividend Threshold. Thus, it may be argued that it would be inappropriate in the context of the transfer of shares of CFC to require the acquiring USSH to take into account dividends paid to the prior owner in computing the acquiring USSH’s Dividend Threshold.

On the other hand, the statutory language itself does not indicate any limitation on the application of section 41(f)(3) principles to changes in ownership of a USSH (and not also changes in ownership of a CFC). Further, the Senate version of the enacted legislation provided, “Rules similar to the rules of section 41(f)(3) shall apply in the case of acquisitions or dispositions of controlled foreign corporations.” Neither the Joint Committee on Taxation’s summary of differences between the House and Senate versions of the enacted legislation, nor the Conference Report, indicates that the changes in the legislative language were intended to eliminate the application of section 41(f)(3) principles to acquisitions or dispositions of CFCs. Finally, applying the carryover rules of section 965(c)(2)(C)(i) to acquisitions and dispositions of assets generating the tax-favored item under section 965 (i.e., CFC stock generating dividends) is conceptually similar to the application of the carryover rules of section 41(f)(3) to acquisitions and dispositions of assets generating the tax-favored item under section 41 (i.e., trades or businesses generating research expenditures). Consequently, we believe it may be difficult to avoid the conclusion that acquisitions and dispositions of CFCs are required to be taken into account in determining the Dividend Threshold of an acquiring or disposing USSH.

iii. Relevance of Increase in Dividend Threshold by Transferee/Reduction in Dividend Threshold by Transferor

Section 41(f)(3)(B) provides that in order for a disposition to result in a reduction of the relevant base amount, the disposition must give rise to an increase in another taxpayer’s base amount pursuant to section 41(f)(3)(A). It is not clear whether this provision has any relevance under section 965. For example, should it matter that a CFC is sold to a foreign person or

26 Other commentators have concluded that the acquirer of a CFC should not be required to take into account, in computing its own Dividend Threshold, the amount of any distributions made by the CFC to its previous owner. See Letter from Linda E. Carlisle to Barbara M. Angus, International Tax Counsel, Treasury Department (Dec. 2, 2004), reprinted in LEXIS at 2004 TNT 248-77; see also New York State Bar Ass’n, Tax Section, Report on the Effect of Mergers, Acquisitions and Dispositions on the Application of Code Section 965 (March 18, 2005).
otherwise ceases to be a CFC as a result of a disposition? Under such circumstances, should the disposing USSH not obtain the benefit of a reduction in Dividend Threshold since the acquirer does not have an offsetting increase in Dividend Threshold? Similar issues arise with respect to sales of equity interests in CFCs to persons who are not entitled to the section 965 DRD, such as individual taxpayers or domestic corporations that do not acquire or own enough of the CFC to be treated as USSHs.27

It also is not clear whether an acquiring USSH should be required to increase its Dividend Threshold with respect to an acquisition of the stock of a foreign corporation that becomes a CFC as a result of such acquisition. As previously stated, section 965 was intended to increase repatriations from CFCs to USSHs. Consequently, we believe it would be inappropriate to require an acquiring USSH to increase its Dividend Threshold based upon dividends paid by an acquired CFC other than to USSHs, or prior to the date that the CFC constituted a CFC.28 The outcome of these issues are not clear under the statute, however, and guidance is needed.

iv. Acquisitions and Dispositions of Trades or Businesses/Section 338 Elections

We believe that the different contexts in which sections 41 and 965 operate suggest differences in approach when applying section 41(f)(3) principles to section 965. For example, section 41 focuses on research expenditures made as part of a given taxpayer’s trade or business; thus acquisitions and dispositions of trades or businesses are taken into account to determine whether research expenditures in a trade or business have increased.29 By contrast, the Dividend Threshold is based on dividends received from CFCs. Because a CFC’s acquisition or disposition of a trade or business without more would not necessarily increase or decrease its capacity to pay an extraordinary dividend, we believe acquisitions of trades or businesses by a USSH or CFC generally should be ignored in computing Dividend Thresholds.

We recognize that a CFC’s sale of its assets may in some cases effectively transfer its dividend paying capacity to another CFC. Nonetheless, because there has been no change in ownership of the asset (CFC stock) that may give rise to the tax-favored item (CFC dividends), we believe no change should be permitted or required in computing the Dividend Threshold of either a USSH of the CFC disposing of its assets or a USSH of the acquiring CFC. While we note the similarity under some circumstances of a qualified stock purchase of a CFC, with respect to which the acquirer makes a section 338 election, to an asset purchase by a newly formed CFC owned by the acquirer, because there has been a change in ownership of CFC stock

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27 Additional issues arise with respect to a USSH’s taxable or tax-free exchanges of stock in one CFC for stock in the same or another CFC, when the USSH loses its status as such as a result of the exchange.

28 Compare H.R. 4520 as introduced in the Senate (proposing new section 965(c)(5)) (“Rules similar to the rules of section 41(f)(3) shall apply in the case of acquisitions or dispositions of controlled foreign corporations occurring on or after the first day of the earliest taxable year taken into account in determining the fixed base period.”) Under this formulation, it may be argued that an acquisition of a foreign corporation that was not, prior to the acquisition, a controlled foreign corporation does not trigger application of the carryover rules.

29 See I.R.C. § 41(b) (defining qualified research expenses to mean certain amounts “which are paid or incurred by the taxpayer . . . in carrying on any trade or business of the taxpayer.”)
in the former case (and the seller in such case is treated as selling stock for federal income tax purposes), we believe that a Dividend Threshold adjustment under section 965(c)(2)(C)(i) is warranted notwithstanding the section 338 election.

v. Effect of Seller’s Section 1248 Inclusion on Acquirer

As described above, upon a USSH’s disposition of shares of a CFC that made distributions during the Base Period, it may be appropriate to reduce the USSH’s Dividend Threshold to reflect the elimination of the USSH’s ownership of the CFC’s stock and corresponding elimination of the opportunity to receive dividends from such CFC in satisfaction of the Dividend Threshold. In the event the CFC stock is acquired by a domestic corporation that is or becomes a USSH with respect to the CFC, the question arises whether any increase in Dividend Threshold of the acquiring USSH should be adjusted to take into account the treatment of the disposing USSH’s gain as a section 1248 dividend.

By virtue of the disposing USSH taking into account a section 1248 dividend, the acquiring USSH may not have increased its ability to receive dividends eligible for the section 965 DRD, since the amount taken into account as a section 1248 dividend by the disposing USSH generally will give rise to PTI, which must be distributed by the acquiring USSH before any additional distributions to such USSH may be counted toward satisfaction of the Dividend Threshold or treated as dividends eligible for the section 965 DRD.\textsuperscript{30} Thus, when a disposing USSH takes into account a section 1248 dividend, an acquisition of a CFC may actually reduce, not increase, an acquiring USSH’s ability to receive dividends eligible for the section 965 DRD.

Example. USSH 1 owns all of the outstanding stock of CFC A. On December 31, 2003, USSH 1 disposes of all its CFC A stock to USSH 2. CFC A has $50 of undistributed earnings and profits at the time of the disposition and has paid $25 of dividends to USSH 1 each year. As a result of the disposition, USSH 1 takes into account a $50 section 1248 dividend. Following the acquisition, USSH 2 has a $50 PTI account with CFC A. USSH 2 also owns CFC B, which has $50 of undistributed earnings. Without regard to its acquisition of CFC A, USSH 2’s Dividend Threshold is zero.\textsuperscript{31}

Although not completely clear, section 965(c)(2)(C)(i) indicates that USSH 1 should reduce its Dividend Threshold by $25 and USSH 2 would increase its Dividend Threshold by the same amount as a result of the acquisition of CFC A. Following the acquisition, CFC A’s first $50 of distributions to USSH 2 would not count toward satisfaction of this increased Dividend Threshold, since USSH 1’s section 1248 dividend caused these to be treated as distributions out of PTI, which are not counted toward satisfaction of the Dividend Threshold. Consequently, USSH 2 will need to receive $25 of fully taxable dividends from CFC B, before any further dividends from CFC B may qualify for the section 965 DRD.

\textsuperscript{30} See I.R.C. § 959(e) (section 1248 dividends are treated as subpart F inclusions for purposes of section 959).

\textsuperscript{31} For clarity of illustration, it is assumed that USSH 1 and USSH 2 owned no other CFCs during the relevant periods.
While it thus may be argued that section 1248 dividends recognized by a disposing USSH should offset or be counted toward satisfying all or part of the Dividend Threshold attributable to a disposed CFC that is taken into account by the acquiring USSH, we believe the increased complexity of such a rule may make it extremely difficult to administer. Thus, on balance, we suggest that the increase in the acquiring USSH’s Dividend Threshold should be unaffected by the disposing USSH’s recognition of a section 1248 dividend.

vi. Taxable Versus Tax-Free Dispositions/Acquisitions

Consistent with the rules under section 41(f)(3), whether a transaction is taxable or not seems irrelevant for purposes of determining whether an adjustment should be made to a USSH’s Dividend Threshold. For example, a deconsolidation resulting from a distribution of 21% or 60%, of a member of an affiliated group filing a consolidated federal income tax return would seem an appropriate adjustment event. Likewise, whether a disposition of interests in a CFC is taxable or not seems irrelevant. The special rule on spinoffs described below addresses only distributions qualifying under section 355. We do not believe that provision should restrict the types of extraordinary transactions encompassed by section 965(c)(2)(C)(i).

vii. Time of Relevant Extraordinary Transactions

As to the relevant time period during which extraordinary transactions should be taken into account for purposes of the calculation of the Dividend Threshold, we note that the version of section 965 introduced in the Senate considered “transactions occurring on or after the first day of the earliest taxable year taken into account in determining the [Base Period]” (i.e., generally, on or after the first day of the first of the Base Period years considered). Section 41 effectively takes a similar approach, and we believe this approach is appropriate. Thus, we believe extraordinary transactions consummated at any time from the beginning of the first year that may be considered part of the Base Period through the close of the Election Year may potentially give rise to adjustments in the Dividend Threshold.

It is possible that an extraordinary transaction may occur after the adoption of a DRIP by a USSH or even after the payment of a dividend by an affected CFC or another CFC. We note that the statute does not make a dividend paid by a CFC ineligible under section 965 merely because the CFC is disposed of during an Election Year. If, however, a dividend in fact is received from a disposed CFC during an Election Year, then it may be appropriate to apportion the distributions actually received during prior years from the disposed CFC (perhaps based upon

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32 H.R. 4520 as introduced in the Senate (proposing new section 965(c)(5) (unenacted)).

33 While the special rule on spinoffs in section 965(c)(2)(C)(ii) applies only to distributions during the five-year period just described (and not after such period), we see no reason why a different rule would apply to distributions occurring between the end of such period and the end of the Election Year. See below for a discussion of spin offs.

34 We do not believe that the statutory application of section 41(f)(3) rules “for purposes of [the Base Period Years]” should limit the application of such rules to extraordinary transactions occurring during the relevant five-year period. Rather, consistent with section 41(f)(3), extraordinary transactions occurring during the current year may require a taxpayer to take into account certain events occurring with respect to a predecessor in interest during the relevant five taxable years of the taxpayer.
the pro rata part of the CFC’s current and accumulated earnings and profits that are distributed to
the disposing USSH during the year of the disposition) in computing the respective Dividend
Thresholds of the disposing and acquiring USSHs, in order to reflect the fact that the disposing
USSH may not have disposed of, and the acquiring USSH may not have acquired, the entire
dividend paying capacity of the CFC for the Election Year.35

viii. Relevant Threshold for Dispositions/Acquisitions Triggering
Adjustments; Manner of Making Adjustments

A USSH is defined by reference to its ownership of at least 10% of the voting stock of a
CFC, taking into account direct, indirect and constructive ownership. Consequently, it is clear
that the Dividend Threshold may take into account dividends received by a USSH from a CFC in
which it owns a relatively small minority interest, as well as dividends received from a CFC of
which the USSH owns all of the outstanding equity interests. While it may be possible to require
any change in ownership of a USSH’s CFC stock to trigger an adjustment to the USSH’s
Dividend Threshold, we believe that the technical accuracy gained by requiring such adjustments
quickly becomes outweighed by administrative complexity when a USSH does not dispose of the
majority of its interest. Further, we note that section 41 suggests a more than 50% test (“the
major portion”) for triggering adjustments. Consequently, we believe it would be appropriate to
ignore lesser dispositions of a USSH’s equity interest in a CFC and make no adjustments to the
USSH’s Dividend Threshold unless it disposes of more than 50% of its equity interest therein.

Upon such a triggering disposition, we believe adjustments should be made in full (i.e.,
ignoring the interest retained) when the disposing corporation loses its status as a USSH by
virtue of the disposition. In other situations, partial adjustments seem to be appropriate, based
upon the pro rata part of the equity interest that has been disposed as compared with that
retained. In the event a USSH disposes of one of several CFCs or interests in CFCs, we note that
the section 41 analogue allocates expenses and gross income to the business to which they are
“attributable,” for which purpose they are traced. In the context of section 965, unlike expenses
and income of a business, the particular CFC from which distributions or investments in U.S.
property were made is more arbitrary. Nevertheless, it appears that a tracing approach in fact
should be adopted for determining the adjustment to the Dividend Threshold of a USSH. Indeed,
that is the approach taken in section 965(c)(2)(C)(ii), which is more specific with respect to
section 355 distributions, and since the Dividend Threshold is the result of distributions that have
already taken place, it cannot be manipulated with section 965 in mind.

35 Of course, we do not believe that an acquiring USSH should be entitled to a dividend received deduction with
respect to dividends received by another taxpayer (e.g., an acquired USSH prior to the date the USSH joined the
group). Nonetheless, an alternative to the approach stated in the text would be to require the acquirer to
increase its Dividend Threshold to take into account the full amount of distributions received by its predecessor
during prior years, but then allow the acquirer to credit dividends actually received by its predecessor during the
acquirer’s Election Year toward satisfaction of the acquirer’s Dividend Threshold. Cf. ILM 200234063
(“Taxpayer should include all of the qualified research expenditures paid or incurred by [the acquired] Corporation for the . . . period [during the current taxable year] before [such] Corporation became a member of Taxpayer’s consolidated group . . . in computing its research credit for the taxable year.”). For further
discussion, see below regarding the entry or departure of a USSH from a consolidated group during an Election
Year.

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ix. USSH Entering or Departing a Consolidated Group in an Election Year

As indicated above, we believe the entry or departure of a USSH from a consolidated group should be taken into account in determining the group’s Dividend Threshold. For example, we believe that a consolidated group that acquires a domestic corporation that is a USSH of a CFC (and would be a USSH of such CFC on a stand-alone basis) should compute its Dividend Threshold by taking into account distributions received by the USSH in prior periods from CFCs to the same extent as if a member of the consolidated group had actually received the distributions. When such an acquisition occurs during the Election Year of the group, however, special issues arise.

We note that the taxable year of a USSH will terminate as a result of its acquisition by a consolidated group, and thus it may be entitled to the benefits of section 965 with respect to dividends it receives during such short year (or even a prior year). In the event the USSH actually receives a dividend from a CFC during its short year, we believe it would be appropriate to reduce the USSH’s Dividend Threshold for purposes of applying section 965 to such year to reflect the fact that it has not had an entire year to satisfy the applicable threshold. At the same time, it would seem appropriate to require the acquiring group to increase its Dividend Threshold to take into account only a pro rata part of distributions actually received by the USSH during the five base period years of the acquiring group, to reflect the fact that the acquiring group may not have acquired the full dividend paying capacity of the CFC for the Election Year. We believe that both of these computations generally should be made in accordance with the manner described above for apportioning prior year distributions between a USSH that disposes, and a USSH that acquires, a CFC during an Election Year.

We also note, however, that it may be consistent with section 41(f)(3) to increase the acquiring group’s Dividend Threshold to take into account the full amount of any distributions actually received by the USSH during the relevant five base period years of the group, but then to credit any dividends actually received by the USSH during the acquirer’s Election Year (including those received prior to the USSH’s acquisition by the acquiring group) toward satisfaction of the group’s newly-increased Dividend Threshold. Since the section 41(f)(3) rules are literally applicable under section 965(c)(5)(C) only for purposes of the base period years, however, it is not completely clear that dividends received by another taxpayer may be taken into account in determining satisfaction of the acquirer’s Dividend Threshold.

b. Section 355 Distributions of a USSH

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

37 We note that section 41 generally requires annualization for short periods. See § 41(f)(4). This rule is not incorporated in section 965 but may constitute an appropriate alternative for determining the appropriate reduction in a USSH’s Dividend Threshold under certain circumstances.
38 See ILM 200234063. Again, we do not believe that the acquirer may claim a section 965 DRD with respect to dividends received by another taxpayer.
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).\textsuperscript{39} 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).\textsuperscript{40} Such apportionment of the pre-distribution base period amount based on post-transaction ownership seems to be a reasonable approach, consistent with the discussion above for other extraordinary transactions 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 was considered necessary, and why it is confined to distributions during the five-year period taken into account in determining the Base Period. We believe the Technical Corrections Bill should include a provision that requires adjustments to be made in the event of a spinoff 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.

3. $500 million/APB 23 Ceiling Limitation

The amount of dividends qualifying for the section 965 DRD may not exceed the greater of $500 million or the amount “shown” on the “applicable financial statement” with respect to the USSH as “earnings permanently reinvested outside the United States” (the greater of such amounts is referred to herein as the “Ceiling Limitation”).\textsuperscript{41} The phrase “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. Accordingly, the earnings permanently (more accurately, indefinitely) reinvested outside the United States are referred to as the “APB 23 amount.” If there is no applicable financial statement, or no such permanently reinvested earnings (or corresponding U.S. tax liability) are shown thereon, the Ceiling Limitation is the floor amount of $500 million.

a. Calculation Inconsistency

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 the wrong 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

\textsuperscript{39} I.R.C. § 965(c)(2)(C)(ii)(I).
\textsuperscript{40} Id. § 965(c)(2)(C)(ii)(II), (III).
\textsuperscript{41} I.R.C. § 965(b)(1).
by 0.35 may substantially understate the corresponding income. This inconsistency was quickly discovered and made the subject of a colloquy involving Senators Grassley and Santorum.\textsuperscript{42} 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.\textsuperscript{43} Subsequently, certain Government officials expressed the view that this inconsistency was not unintentional, and that it was in keeping with the legislative intent not to incorporate or refer to records not formally part of the applicable financial statement. Nevertheless, we believe that the significance of the difference in results, the relatively minor extent of external reference required, and the arbitrariness of the results under the current statute all suggest that guidance be issued that permits taxpayers to increase the amount of U.S. tax liability shown in financial statements, for purposes of computing the Ceiling Limitation, by the amount of U.S. foreign tax credit reflected in computing such U.S. tax liability.

b. Allocating Ceiling Limitation Among Multiple USSHs

For purposes of section 965, all USSHs that are members of an affiliated group filing a consolidated federal income tax return are treated as a single USSH. Nonetheless, there are situations in which more than one USSH (taking into account this consolidated group rule) may be part of a controlled group for which all or part of the Ceiling Limitation is measured on a group-wise basis.\textsuperscript{44} The statute, however, does not provide any specific direction to divide the Ceiling Limitation based on acquisitions or dispositions of CFCs or USSHs.\textsuperscript{45} Thus, in publishing guidance to deal with such situations, the Treasury Department may be limited to exercising its authority under sections 381 and 1502, as well as its general interpretive authority under section 7805(b).\textsuperscript{46}

\textsuperscript{42} 150 Cong. Rec. S11019, S11036 (Oct. 4, 2004).
\textsuperscript{43} Id.
\textsuperscript{44} I.R.C. §965(c)(5)(B), 965(c)(5)(C).
\textsuperscript{45} H.R. 4520 as introduced in the Senate but not enacted proposed new section 965(c)(5) as follows: “For purposes of this section . . . Rules similar to the rules of section 41(f)(3) shall apply in the case of acquisitions or dispositions of controlled foreign corporations occurring on or after the first day of the earliest taxable year taken into account in determining the fixed base period.” As noted above, section 965(c)(2)(C)(i) applies only for purposes of paragraph (2), dealing with the Base Period. Moreover, the section 41(f) rules do not appear to be directed toward adjustments of items such as a Ceiling Limitation, which imposes a ceiling on a taxpayer’s maximum benefit based upon a financial statement prepared as of a given point in time. Instead, the section 41(f) rules are directed toward determining an appropriate threshold of expenditures based upon average expenditures over a given period of years, during which an acquisition or disposition may have occurred.

\textsuperscript{46} Other commentators have ably described the conceptual benefits of adjusting the Ceiling Limitation as a result of acquisitions and dispositions. See New York State Bar Ass’n, Tax Section, Report on the Effect of Mergers, Acquisitions and Dispositions on the Application of Code Section 965 (March 18, 2005). In general, such adjustments generally would (i) limit a disposing taxpayer’s ability to benefit from the statute to the extent it directly or indirectly disposed of CFCs responsible for an APB 23 amount, (ii) increase an acquiring taxpayer’s ability to benefit from the statute to the extent it directly or indirectly acquired CFCs that contributed to an APB 23 amount of a disposing taxpayer and (iii) generally coordinate adjustments to the Ceiling Limitation with adjustments to the Dividend Threshold. We note that even without making such adjustments, however, in all events taxpayers generally should have at least a $500 million Ceiling Limitation.
i. $500 Million Base Limitation

Under section 965, all corporations treated as part of a single employer under section 52(a) (which provides grouping rules for purposes of the “work opportunity credit” and “welfare-to-work” credit) are limited to a single $500 million base for purposes of computing the Ceiling Limitation.\(^\text{47}\) A single employer for this purpose includes a “controlled group of corporations” within the meaning of the quoted term in section 1563(a), except that (i) “more than 50 percent” is substituted for “at least 80 percent” and (ii) subsections 1563(a)(4) and 1563(e)(3)(C) are disregarded.\(^\text{48}\) The section 52 rules, which apportion credits to corporations included in the controlled group in proportion to their shares of wages giving rise to the credit, offer no guidance as to the measure of apportionment for purposes of section 965.

The statute does not indicate the date(s) on which single employer status is to be measured. Under such circumstances, it seems likely that the status should be tested only during the Election Year or Election Years of the various members of the group, as that is when the provision generally applies under section 965(f). Under that approach, if a standalone USSH became a member of a controlled group of corporations prior to or during its Election Year (such that it was a member of such group, but did not join in filing a consolidated return with such group, at some point during its Election Year), such USSH and the other members of the group would be collectively entitled to a single $500 million base amount for purposes of computing the USSH’s applicable Ceiling Limitation.\(^\text{49}\)

By contrast, if prior to the Election Years of the component members of a group, a group member left the group (e.g., the common owner of the group were to dispose of a member owning a CFC), such member and the remaining group each would have at least a $500 million Ceiling Limitation. If the group member left the group and joined a new group during an Election Year, more difficult questions arise regarding the departing member’s entitlement to benefit from an acquiring group’s separate $500 million base amount. Nonetheless, we believe such questions generally should be resolved in favor of ease of administration. One solution may be to permit the departing member to take advantage of the greater of its allocable share of the departing group’s or the acquiring group’s $500 million base amount. In any case in which a $500 million base amount is allocable between or among corporations, we believe an appropriate general rule would be to apportion the amount between or among the corporations in proportion to the “all earnings and profits” amounts (without regard to indefinite investment status) of the CFC shares held by them as of the end of the most recently closed taxable year. An alternative would be to permit group members to apportion the $500 million base amount by agreement.\(^\text{50}\)

ii. APB 23 Amount

\(^{47}\) I.R.C. § 965(c)(5)(B).

\(^{48}\) Id. § 52(a).

\(^{49}\) If prior to a binding agreement for a transaction resulting in a stand alone USSH becoming a member of a controlled group, the stand alone USSH received dividends that it was committed to reinvest pursuant to a DRIP, and the single $500 million base amount would result in disqualification of dividends already received, then it may be appropriate to permit a separate $500 million base amount, at least to the extent of such excess dividend.

\(^{50}\) Compare Treas. Reg. § 1.1561-3 (apportionment of surtax exemption by agreement).
Section 965 also provides that, if a financial statement is “an applicable financial statement for more than [one USSH]” (i.e., includes more than one USSH), then the APB 23 amount shown thereon must be divided between or among such USSHs under regulations to be promulgated.\(^\text{51}\) Again, all USSHs that are members of a single consolidated group are “treated as one [USSH].”\(^\text{52}\) Thus, multiple USSHs that do not meet the threshold common ownership or control for tax consolidation but do meet the threshold common ownership or control for financial statement consolidation may be required to divide up an APB 23 amount stated on their collective financial statement (for example, if one such USSH is a section 936 company). We believe this rule also applies, in the limited circumstances described below, in which multiple USSHs are created or separated as a result of an extraordinary transaction occurring after the date of an applicable financial statement.

For example, we believe that if a domestic corporation owning a CFC with respect to which there is an APB 23 amount is sold or spun off by a consolidated group, or otherwise deconsolidated, between the date of the applicable financial statement for the consolidated group and its subsidiaries and the end of its Election Year, such that the domestic corporation is a standalone USSH, then the consolidated group’s financial statement is “an applicable financial statement for more than [one USSH]” (namely, the continuing consolidated group and the spun off or deconsolidated USSH) and the deconsolidated USSH should take into account some portion of the APB 23 amount shown on such financial statement.

It is less clear whether such a division may be required under the statute upon the acquisition of a domestic corporation owning a CFC by another domestic corporation, which then includes the target domestic corporation in its own consolidated return (and may or may not have its own applicable financial statement). In such a case, it is less clear that the applicable financial statement of the selling group should be treated as an applicable financial statement for more than one United States shareholder, since the “United States shareholders” at issue are the selling and the buying consolidated groups and not any individual members, and there is some difficulty in saying that the statement for the reporting group that includes the seller also “includes” the buyer. Thus, in crafting appropriate guidance, the Treasury Department may be limited to relying on its authority under sections 381 and 1502 as well as its general interpretive authority under section 7805(b).

Notwithstanding the limited authority, we believe that failing to make adjustments upon extraordinary transactions occurring after a financial statement date may stifle the legislative purpose of promoting repatriations of deferred earnings. Thus, in general terms, we believe adjustment of the APB 23 amounts would be appropriate upon acquisitions and dispositions of domestic corporations that own CFCs (and, to the extent adjustments are required to be made to the Dividends Threshold upon acquisitions or dispositions of CFCs, in such circumstances as well). The simplest case for guidance in this area would involve aggregation of APB 23 amounts upon acquisition of one reporting group by another reporting group. Other situations, for example, the purchase of a domestic corporation owning CFCs out of a consolidated group,

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\(^{51}\) I.R.C. § 965(c)(5)(B).

\(^{51}\) Id. § 965(c)(5)(C).

\(^{52}\) Id. § 965(c)(5)(A).
presents significantly more difficult technical issues. Nonetheless, we believe the allocation principles applied in such situations generally should follow the principles to be applied in the context of the separation of a standalone USSH from a reporting group.

We believe an appropriate general rule for allocating APB 23 amounts would be to allocate such amounts in proportion to the relevant USSHs’ respective shares of the aggregate indefinitely reinvested earnings and profits of all the CFCs reflected in the applicable financial statement, as of the date of such statement. A simple way to do this would be to allocate in proportion to the “all earnings and profits” amounts attributable to CFC shares held by USSHs as of the beginning of the Election Year. An alternative, to more closely track the indefinitely reinvested earnings, may be permitted in the event the relevant APB 23 amount can be attributed to specific CFCs based on available documentation. In such a case, the APB 23 amount would first be allocated among the relevant CFCs that generated the earnings in question, and otherwise apportioned among the relevant CFCs in proportion to their respective all earnings and profit accounts as of the end of the relevant financial statement date. If a CFC has more than one USSH that is included in the applicable financial statement, the relevant APB 23 amount attributable to such CFC then would be allocated to such USSHs in the same proportion as such USSHs would include income under section 951(a)(1)(A) from the CFC, to reflect amounts that could be distributed to them.

IV. Funding the Dividend

As indicated above, a dividend qualifies for the section 965 DRD only if it is paid in “cash.” While some CFCs will have cash readily available for distribution, many CFCs will not. These CFCs will need to obtain the cash from one or more sources, including sales of assets and borrowing. Notice 2005-10 acknowledges this and provides some helpful guidance. Additional guidance, however, is needed.

1. Limitation on Related Party Borrowing

Section 965 limits the ability of a CFC to borrow from a related person to fund a dividend qualifying for the section 965 DRD. Under section 965(b)(4), qualifying dividends are reduced, dollar-for-dollar, by the increase in the CFC’s indebtedness to related persons (“related party indebtedness”) after October 3, 2004. Specifically, the reduction is equal to the excess of (i) related party indebtedness existing as of the close of the Election Year, over (ii) the amount of related party indebtedness as of the close of October 3, 2004. In calculating the amount of related party indebtedness, indebtedness between CFCs of a single USSH is disregarded.

The Conference Report describes the purpose of the related party indebtedness rule as follows:

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 the payment of a dividend from a controlled foreign corporation. In such a case,
there may be no net repatriation of funds, and thus it would be inappropriate to provide the deduction.\footnote{H.R. Rep. No. 108-755, at 67.}

The related party indebtedness rule raises a number of issues for which guidance is urgently needed. Notice 2005-10 does not directly address these issues.

a. Determination of Amount of Related Party Indebtedness

Read narrowly, the related party indebtedness rule would simply require snapshots of related party indebtedness at 11:59 p.m. on October 3, 2004 and at the same time on the last day of the Election Year, and subtract the former from the latter, to determine whether there has been an increase in related party indebtedness during the time frame associated with the payment of a dividend. As such a mechanical rule could give rise to significant abuse, the Technical Corrections Bill would add regulatory authority to prevent the avoidance of the related party indebtedness rule.

As drafted, the regulatory authority under the Technical Corrections Bill would not extend to making the statute less restrictive, and it might be considered questionable whether the statute otherwise would be conducive to creating exceptions on an interpretive basis. Consequently, in order to implement certain of the following suggestions, additional authority under the Technical Corrections Bill could be required.\footnote{While the legislative history indicates that the purpose of the related party indebtedness rule is to prevent abusive indirect funding of a dividend, the statute does not provide broadly for legislative regulations and provides no exceptions for certain types of indebtedness.}

First and foremost, we recommend that guidance permit a single currency translation rate to be used for the two testing points.\footnote{Cf. Treas. Reg. §1.864-10(e)} Otherwise, the comparison would be fundamentally inconsistent.

To the extent authority would exist, in the case of an acquisition of a U.S. corporation or group 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.

To the extent authority would exist, consideration should be given to determining the “amount” of related party indebtedness not based simply upon indebtedness existing at specific moments in time but rather adjusted for seasonal levels of related party indebtedness.\footnote{Cf. Treas. Reg. § 1.861-10(e).}

To the extent authority would exist, we also would recommend that Treasury provide exceptions from the definition of related party indebtedness for indebtedness that arises in certain ordinary business transactions between a CFC and related persons. For example, we believe receivables arising from the sale of inventory or provision of back office services by a U.S.
person to a CFC might not be treated as giving rise to related party indebtedness. Consideration also should be given to excluding other common business transactions occurring in the ordinary course of business or that do not truly transfer liquidity, such as security loans collateralized by an equivalent amount of liquid assets, from transactions that give rise to related party indebtedness. Such exceptions would be desirable not just to deal with seasonal differences or growth of the business but also the burden of compliance.

Another example of related party indebtedness that may result without any intention to manipulate amounts repatriated is the interest-bearing account receivable permitted to be established between a U.S. taxpayer and a related corporation under Rev. Proc. 99-32, 1999-2 C.B. 226 (§4) in connection with an IRS-initiated adjustment under section 482 or a taxpayer-initiated adjustment under Regulation section 1.482-1(a)(3). We recommend that consideration be given to permitting relief in such a case.

We also believe that a provision should be added to the Technical Corrections Bill to permit taxpayers to elect to use a September 30, 2003, rather than October 3, 2003, cutoff date in order to comport with the realities of bookkeeping and public accounting.

b. Related Party Guarantees of Third Party Borrowings

In light of the related party indebtedness rule, a CFC that does not have cash available to make a distribution may need to borrow from another CFC or from an unrelated lender. Notice 2005-10 acknowledges this likelihood in connection with the confirmation that a USSH need not demonstrate that there has been a net global reduction in indebtedness of its worldwide corporate group in order for the repayment of third party debt to qualify as a permitted investment. The Notice posits a case where a CFC borrows to fund a cash dividend to its U.S. shareholder, which then uses the funds, pursuant to its DRIP, to repay indebtedness owed to an unrelated party. The example concludes that a U.S. shareholder may be able to demonstrate that the shareholder’s repayment of debt is a permitted investment even though the total debt of the taxpayer and its CFCs, taken in the aggregate, is not reduced. The example cautions, however, that the CFC must be treated as the obligor of its borrowings under U.S. tax principles, citing Plantation Patterns v. Commissioner, 462 F.2d 712 (5th Cir.), cert. denied, 409 U.S. 1076 (1972). Thus, if the facts and circumstances demonstrate that, in substance, the shareholder, rather than the CFC, is the obligor of the CFC’s borrowing, the shareholder’s repayment of its third party debt would be transitory and not a permitted investment.

Applying the example in the Notice to the issue of related party indebtedness, if a related person guarantees the CFC’s third party borrowing, the guarantee should not cause the borrowing to be treated as related party indebtedness as long as the CFC remains the obligor of the borrowing under U.S. tax principles. We recommend that Treasury confirm this inference in subsequent guidance. We note that such guidance would be consistent with guidance provided in other areas, such as the conduit financing rules promulgated under section 7701(l). For purposes of these rules, guarantees are generally ignored in determining the true lender in a

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57 Compare § 956(c)(2)(C).

58 See also Tax Section Letter on Technical Corrections, note 13 above.
multiparty financing transaction.\textsuperscript{59} It was evidently concluded that for such purposes a guarantor, while providing credit support, should not be treated as the source of funds loaned to the borrower.\textsuperscript{60}

More specifically, while a guarantor generally provides some value to the borrower, unless the guarantor is expected from the outset to repay the CFC’s indebtedness, we do not believe the guarantor should be viewed as the actual source of CFC cash. Consequently, we believe guidance should not characterize third party loans as related party indebtedness except to the extent the CFC could not have obtained a loan, even if on different terms and from different lenders, but for the related party guarantee or other support. When the CFC has the financial wherewithal to obtain the loan on its own credit and is in a position to repay the loan using its own resources, we believe the purpose of the related party indebtedness limitation in section 965 is not avoided. In these cases, the USSH would not have, directly or indirectly, financed the loan, and any distribution by the CFC would truly represent a net repatriation of funds from the CFC to the USSH.

c. Other Arrangements: Related Party Financing Conduits

As drafted, the statute seems to preclude a related party borrowing even if the related party lender is acting as a conduit in a financing arrangement.\textsuperscript{61} We believe Treasury should consider permitting a CFC borrowing in this case because it is economically similar to a related party guarantee.

2. Priority of Paragraph (1) Versus (3) of Section 965(b)

The application of section 965(b) in the context of a taxpayer intending to distribute the maximum amount allowable under section 965(b)(1) can have surprising, and we believe unwarranted, results.

Example. Assume a Base Period amount of $200M and a Ceiling Limitation of $500M. Absent an increase in related party indebtedness, the taxpayer would have to receive $700M of cash dividends from its CFC during the Election Year (in addition to distribution of any PTI of the CFC) to make full use of the section 965 DRD after taking into account the Dividend Threshold under section 965(b)(2). If related person indebtedness increased by $100M for purposes of section 965(b)(3), then only $400M of the $700M repatriation would qualify for the DRD.

Suppose that a taxpayer, in order to address the effect of the related person indebtedness, had the CFCs pay out another $100M of cash dividends during the Election Year, i.e., pay $800 of dividends in order to claim the 85% DRD on $500M. Literally, section 965(b)(3) appears to require a calculation of the

\textsuperscript{59} See Treas. Reg. § 1.881-3.

\textsuperscript{60} While sections 163(j) and 956 take a different approach to guarantees, finding the credit support aspect sufficient to invoke operative rules, neither attempts to determine the true source of the borrowed funds.

\textsuperscript{61} Cf. Treas. Reg. §1.956-2(c)(4).
maximum qualified dividend as limited by paragraphs (1) and (2) of section 965(b) (amount permitted under section 965(a) “but for” section 965(b)(3), which here would be capped at $500M, due to the Ceiling Limitation) and then a reduction of that amount by the $100M to $400M, making it impossible to offset the increase in related party indebtedness.

We believe that this result is inappropriate and should be corrected, either administratively or through a technical correction.

3. Anti-Abuse Rule of Technical Corrections Bill

The Technical Corrections Bill would provide the Treasury Department with explicit regulatory authority to promulgate rules that prevent the avoidance of the related party indebtedness rule. The staff of the Joint Committee on Taxation explains that Treasury regulations could disqualify cash dividends to the extent 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 to a CFC.\(^{62}\) The regulations are “expected” to preclude a section 965 DRD in cases in which the dividend is “effectively funded” by the USSH or its U.S. affiliates.\(^{63}\) The regulations are also expected to “supplement” existing U.S. federal income tax principles relating to the treatment of circular flows of cash.

We recommend that any Treasury guidance issued pursuant to the authority contained in the Technical Corrections Bill generally treat a dividend as being attributable to a direct or indirect transfer of cash or other property only if a factual link exists to establish that a related person to the CFC was directly or indirectly the source of such cash or the ability of the CFC to borrow the cash (with an express exception for normal guarantees as described herein). We are not suggesting, however, that a tracing approach would be applied. Principles similar to those adopted in the conduit financing regulations could be incorporated to address concerns about the use of intermediate entities and indirect financing cases, such as when the USSH deposits funds with a third party, which then lends, on the strength of the deposit, an equivalent amount to the CFC in order to fund the dividend.

In any event, published guidance should provide illustrations of transactions that avoid the purposes of the related party indebtedness rule and those that do not. Consideration should also be given to providing safe harbors for transactions that do not avoid the purposes of the related party indebtedness rule. Safe harbors could include contributions of non-cash property to CFCs (including under section 304) that do not measurably reduce the USSH’s borrowing power or increase the CFC’s borrowing power, related party guarantees of CFC indebtedness when the CFC has the financial wherewithal to support the indebtedness, sales of property for fair market

\(^{62}\) Staff, Joint Committee on Taxation, Description of the Tax Technical Corrections Act of 2004, JCX-70-04 (Nov. 19, 2004), at 3.

\(^{63}\) Id.
value consideration (where the contribution standard cannot be met), and transfers occurring outside of some timeframe surrounding the CFC dividend.  

One situation that should be addressed is the effect of payment by a USSH of payables or other obligations owing to a CFC in connection with a dividend by a CFC for which section 965 qualification is sought. On the one hand, such transfer results in no change in the net worth of the parties. On the other hand, the legislation clearly focuses on liquidity of the USSH. On balance, we believe that if such a transaction departs from cash flows that would have occurred in the ordinary course of business (e.g., prepayment of a loan owed to the CFC or a significant decrease in the amount of trade liabilities owing by the USSH to the CFCs that is not due to seasonal differences or third-party occurrences), then it may be appropriate to treat the transaction as an indirect funding of the dividend.

4. **Cash Dividends**

   a. **General**

   As stated previously, section 965(a)(1) generally provides that only “cash” dividends are eligible for the section 965 DRD. The Technical Corrections Bill would amend section 965(b)(2) to provide that only cash dividends are considered for purposes of satisfying the Dividend Threshold.

   Notice 2005-10 § 3.01 resolves satisfactorily the currency issue relating to cash dividends. The functional currency of the recipient of the dividend is the U.S. dollar. On the other hand, the functional currency of the entity paying the dividend typically would not be the U.S. dollar and, from its standpoint, a dividend paid in U.S. dollars might not be considered a cash dividend. The statute is unclear whether “cash” is to be determined in the hands of the payor or the payee. We commend the IRS and Treasury for providing that the term “cash” includes both U.S. dollars and foreign currency.

   The Notice, however, takes the position that only currency is encompassed by the term “cash.” We see no policy reason to limit transfers qualifying for the section 965 DRD to currency, and believe that the term “cash” could be construed under section 7805(b) regulatory authority to include certain cash equivalents. We recommend that taxpayers be permitted to distribute very short-term time deposits. For example, if a CFC holds a certificate of deposit with a bank with 90 days remaining to maturity, it would seem appropriate to allow that CFC to distribute the certificate of deposit to the USSH without first converting it to cash and possibly incurring breakage costs and then redepositing the funds. We believe the recommendation regarding transfers of certain cash equivalents would carry out the intent of Congress while avoiding unnecessary costs and burdens to taxpayers.

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64 We do not think a general exception for sale of property by a CFC to a USSH, even at fair market value is appropriate, because of the importance under the statute of providing liquidity to the USSH and the fact that that would be tantamount to replacing distributed cash with a prohibited dividend in kind.

65 As a result of applicable exceptions or otherwise, such loans might not be affected by section 956.

66 See Notice 2005-10 § 3.01.
b. Distributions to/from Pass-Through Entities

Notice 2005-10 § 3.02, provides that a cash dividend paid by a CFC to a partnership or disregarded entity (pass-through entity) that is owned by a USSH is treated as received by the USSS only if and to the extent the pass-through entity distributes cash to the USSH in the amount of the CFC dividend during the Election Year. A loan of cash by the pass-through entity is not sufficient. In the case of a partnership, the cash dividend also must be allocated to the USSH-partner under the section 702 and 704 regulations and separately stated to the partner under section 1.702-1(a)(8)(ii).

We believe this approach is called for under the statute and legislative history. In particular, the Conference Report makes clear in the context of the reference to a deemed liquidation effected through an election under section 301.7701-3(c) that a deemed distribution of cash is insufficient. Further, both the requirement that cash be repatriated as a dividend and the reduction in qualified cash dividends for increases in related party indebtedness make clear that a loan of the cash should not suffice.

Notice 2005-10 § 3.03, confirms that the amount of the dividend that must be reinvested is the gross amount, unreduced by any foreign withholding tax or other related taxes or other expenses. This follows from the wording of the statute. On the other hand, a withholding tax on a payment from one foreign entity to a CFC is not required to be added back to determine the amount required to be reinvested, as it is not part of the dividend amount received by the USSH.

V. Domestic Reinvestment Plan Drafting

Section 965(b)(4) provides that, in order for a dividend to qualify for the section 965 DRD, the dividend must be invested in the United States pursuant to a DRIP (i) that is approved by the USSH’s president, chief executive officer, or comparable official before payment of the dividend and subsequently approved by the USSH’s board of directors, management committee, executive committee, or similar body, and (ii) that provides for the reinvestment of such dividend in the United States (within the parameters of certain purposes described in detail in section V below). While the legislative history provides limited discussion of the DRIP requirement, Notice 2005-10 provides much appreciated guidance, though additional examples would be useful.

1. Required Specificity

Section 965(b)(4) does not indicate how specifically a DRIP must describe the use(s) for cash dividends. As described below, it seems that Congress contemplated that the repatriated funds would not necessarily be used immediately upon distribution, and that the details regarding actual expenditures need not have been worked out at the time the plan is adopted. Further, if there is any delay between repatriation and actual use, the use intended at the time of the distribution may become inadvisable or impossible at the time of the planned use. On the other hand, it would seem inappropriate to permit taxpayers to adopt a completely open-ended DRIP, with specific uses for a repatriation to be enumerated only after the distribution of the dividend. Congress clearly wanted the CEO or equivalent officer and the board of directors or equivalent body to consider (with all due analysis and reflection) the DRIP and consequently intended it to
be a meaningful document. This would suggest that the DRIP have a reasonable but not minutely specific amount of detail consistent with such review.

Notice 2005-10 clarifies how much detail a DRIP must contain. We generally agree with the approach taken by the Notice, which relies to a large extent upon the good faith reasonable efforts of taxpayers to comply. First, the Notice clarifies that the DRIP must be in writing and must describe the intended investment “in reasonable detail and specificity.”67 The Notice states that Treasury and the IRS do not intend to provide a template for a domestic reinvestment plan but instead provides for “a facts and circumstances” analysis of whether the DRIP is reasonably detailed and specific.68 As the touchstone for this analysis, the Notice requires that the DRIP “provide sufficient detail to enable the taxpayer to demonstrate - upon examination that the expenditures that subsequently occur were of the kind that were in fact contemplated at the time of the adoption of such plan.”69 We find some tension in this standard, given the reference to “detail,” on the one hand, while the basic requirement of identification is the very broad concept of same “kind.”70

The Notice also provides some concrete guidelines. Taxpayers must specify the dollar amount for each “principal investment” under the DRIP, although they need not specify the dollar amount for each “specific component” of such investments. The Notice states that a DRIP should specify, for example, “a total dollar amount of expenditures for research and development on product lines A, B and C and a total dollar amount for expenditures for advertising for brands D and E.” Thus, the dollar amounts for particular product lines or brands, which apparently are considered specified components of the principal investment need not be specified.

Additional examples of what is meant by a “principal investment” and by specific components would be helpful. For example, would construction of facilities be a principal investment and construction of a research facility in the vicinity of Boston be a specific component? Would payment of wages generally be a principal investment and payment of wages at a particular manufacturing plant be a specific component? Would funding of tort liabilities or repayment of debt be principal investments and funding of a specific tort liability or paydown of a specific debt obligation be specific components? Would acquisitions generally be a principal investment and acquisition of a subsidiary that can perform function X be a specific component?)

Taxpayers may move dollar amounts from one investment specified in a DRIP to another investment that is so specified. This is helpful and gives important flexibility to taxpayers given that (presumably because of the requirement of approval prior to payment of a dividend) amendments to a DRIP are not allowable, under the Notice.71 The ability to shift between

67 Notice 2005 § 4.01.
68 According to the Notice, the facts and circumstances considered should include the specific investments contemplated, the contemplated time period for the investment, and “whether factors beyond the taxpayer’s control could affect its ability to make the contemplated investment.” Notice 2005-10 § 4.03.
69 Notice 2005-10 § 4.03 (emphasis added).
70 Compare the “like kind” concept in section 1031.
71 See Notice 2005-10 § 4.04.
investments, however, raises the question why taxpayers must initially declare a dollar amount for each principal investment. We assume that the requirement that taxpayers specify a dollar amount for each principal investment is included in order to fulfill the statutory purpose of having the board of directors, or similar body, examine and approve a meaningful initial plan.

The Notice also allows a DRIP to set forth alternative investments which can be implemented if the principal investments are “delayed or rejected” for reasons including, but not limited to, actions of other persons (such as denial of government approvals) or a change in “reasonably anticipated business conditions.” The alternative investments must be described in the DRIP with the same specificity as principal investments, and must themselves be acceptable investments under section 965. The DRIP need not list the conditions under which the taxpayer will shift from a principal to an alternative investment. Nor does it appear that actions of a third party or an unforeseen change in circumstances are necessary; the Notice indicates that a decision for good business reasons to spend more on, e.g., advertising and less on R&D is permitted and the excess amount spent on advertising is treated as an alternative investment. Therefore, the alternative investment option appears to serve much the same function as allowing the taxpayer to shift dollar amounts from one principal investment to another.

Given the lenient allowance of alternative investments, the ability to shift dollar amounts between investments, and the inability to amend a DRIP (except for certain dividends paid before January 13, 2005), taxpayers are likely to list multiple principal investments and alternative investments in their DRIPs. We note that the incentive, created by the Notice, to list as many alternative investments as possible could defeat the stated goal of reasonable specificity as well as potentially penalize taxpayers who fail to include sufficient alternative investments in their DRIP. We wonder whether under the circumstances forthcoming regulations (or further notices) should allow taxpayers to amend the DRIP, at least in cases where unforeseen circumstances make a principal investment significantly less attractive than it was at the time the DRIP was first approved. The requirement that the DRIP be approved before the distribution of the dividends to be reinvested could be met, we believe, by the prior approval of a DRIP that is later amended (at least if guidance would deem an ability to amend the DRIP retroactively within limitations to have been included in each DRIP).

2. Time Limit to Adopt DRIP

Section 965 requires that, in order for a dividend to qualify under section 965(a), the DRIP in respect of such dividend must be approved by the taxpayer’s president, chief executive officer, or an official exercising comparable authority prior to the payment of the dividend. Approval of the DRIP by the board of directors or similar body of the taxpayer may occur after the dividend is paid. Notice 2005-10 clarifies that such approval does not require a special meeting. It also states that, in the case of a consolidated group, the required approvals occur at the level of the group’s common parent, and need not be given by any other member of the group, even if other group members are the shareholders of the distributing CFC or make

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72 Notice 2005-10 § 4.04.
73 We assume that board approval could occur by an action without a meeting to the extent permitted under the corporation’s governing documents and the applicable law.
investments under the DRIP. The Notice (§ 4.01) helpfully confirms that a taxpayer may adopt more than a single DRIP. The Notice provides (§ 4.06) that a DRIP may include expenditures made in the Election Year prior to adoption of the DRIP, thus reducing any pressure to adopt a DRIP early in the year.

A technical issue that arises in respect of PTI derives from the fact that, under the section 959(c) rules, current year PTI is considered distributed prior to PTI from prior years. Accordingly, a taxpayer wishing to distribute PTI from prior year subpart F income early in 2005 and designate cash distributions of PTI from later up the chain 2005 dividends as qualifying dividends under section 965(a)(2) would face an issue whether the DRIP must be adopted prior to the first PTI distribution in 2005. We believe that a taxpayer should not be required to adopt a DRIP prior to the date of the first PTI distribution under such circumstances and that such a requirement would be a trap for the unwary. We recommend that guidance treat a DRIP adopted prior to the later of (i) the distribution of the section 965(a)(2) PTI or (ii) the distribution by the CFC or CFCs that created such PTI as timely with respect to section 965(a) “dividends” of such PTI.

Notice 2005-10 provides that, in general, expenditures made during the taxable year for which the taxpayer elects to apply section 965 may be considered to be made pursuant to a DRIP, regardless of when they are made. Accordingly, for example, expenditures on permitted investments made in the election year but prior to the payment of the cash dividend (or prior to the adoption of the DRIP) may qualify as permitted investments made pursuant to the DRIP.

3. Time Horizon for Implementation

Section 965(b)(4) does not require a DRIP to be implemented within any specific period of time. A proposed amendment (the Breaux-Feinstein amendment) to require such investment to occur within three years of the dividend receipt was defeated in the Senate. During the debate on the amendment, the amendment’s opponents showed a preference for trusting that taxpayers would follow their stated dividend reinvestment plans, rather than requiring taxpayers to demonstrate that they had made the required investments within a particular time period. While the amendment contained other controversial provisions, its defeat would tend to support that the required period for investment is not necessarily limited to three years. In light of this legislative history, and the practicalities of making sound investments, we agree with the Notice’s standard, that the DRIP must provide for a “reasonable time period, taking into account the nature of the investments to be made in the United States and other facts and circumstances,” for completion of the DRIP. For example, a contribution to a pension plan could be accomplished very quickly, whereas payments in respect of an R&D project could take several years.

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74 Notice 2005-10 § 4.02.
75 See S. Amendment 2891, S. Amendment 3117.
77 Notice 2005-10, § 4.03.

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Notice 2005-10 also contains a safe harbor that requires that at least 60% of the amount of the intended permitted investments be made, or be the subject of a binding contract or commitment with an unrelated person, by the end of the second year after the year to which section 965 is applied. The safe harbor further requires that the taxpayer represent, in an annual report filed by the end of such second year, that “the taxpayer intends” that all of the permitted expenditures will be made by the end of the fourth taxable year after the year to which section 965 applies. On its face, the Notice provides that, under such circumstances and assuming compliance with a reporting requirement, the taxpayer is deemed to have met its burden of showing that the amount of the dividend was reinvested in the United States pursuant to the DRIP. (Presumably, however, such result is not intended if the remaining dividend in fact is not reinvested, which could be clarified.)

We note that the statute does not make any special provision for the fact that failure to comply with a DRIP may not be known until years after the year for which the section 965 DRD is claimed (i.e., the Election Year). That is, there is no extension of the statute of limitations, escrow requirement, or interest charge mechanism to ensure that a taxpayer who takes advantage of the deduction but then does not comply with its terms is not able to claim a benefit merely due to the running of the statute of limitations.

Notice 2005-10, however, includes a provision to extend the statute of limitations as one of the relevant facts and circumstances to be considered in whether the section 965 requirements are met. The Notice provides that one such fact and circumstance is whether, in an annual report for a taxable year not later than two years after the Election Year, the taxpayer states that it will, upon request, enter into an extension to the statute of limitations for deductions claimed under section 965 and will, “upon a request by the Commissioner, . . . enter into a multi-year agreement with respect to the taxpayer’s completion of the DRIP.” This facts and circumstances test has no application if the safe harbor test is met. Even where that test is met, however, the ultimate reinvestment of the last 40% may be delayed. Accordingly, we recommend that future guidance treat as a positive factor a taxpayer’s agreement to extend the statute of limitations in situations in which the safe harbor is otherwise met but some portion of the reinvestment is delayed.

In the context of an acquisition of a USSH pursuant to which the USSH becomes included in a consolidated tax return filed by the acquiror, the USSH generally will experience a short tax year. If that occurs during the Election Year of the USSH, it will curtail the period during which the USSH may receive qualifying dividends, but whether it occurs during the Election Year or thereafter it would have the effect of accelerating the time needed to comply with the safe harbor. We do not believe that this should be the case, and recommend that the safe harbor be amended to avoid acceleration in such a case.

4. Partial Failure to Comply with DRIP

Notice 2005-10 addresses in a taxpayer-favorable manner the situation in which part of the dividend is invested as required, and part is not.

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78 Id. § 8.03(b).
79 Id. § 8.04(c).
Assume that shareholder X receives a $100 extraordinary dividend pursuant to a DRIP that qualifies under section 965(b)(2), but only $60 of the dividend is invested as required under section 965(b)(4). Is the entire dividend tainted, because the entire “dividend” (or “amount of the dividend”) has not been invested in a permitted use as required by the statute and the taxpayer’s own DRIP approved by the CEO prior to payment of the dividend? Compare the situation in which shareholder Y receives a $60 dividend and then a $40 dividend pursuant to a DRIP, both of which qualify under section 965(b)(2). Y invests the $60 dividend, but not the $40 dividend, as required under section 965(b)(4). The $60 dividend qualifies for the deduction under section 965(a) and the $40 deduction does not.

Notice 2005-10 addresses this problem by allowing section 965(a) to apply to a dividend to the extent that the amount of the dividend is invested as required in section 965(d), if the DRIP provides for qualified expenditures of the entire dividend. The Notice has essentially interpreted the phrase “unless the amount of the dividend is invested” as meaning “except to the extent that the amount of the dividend is invested.” We support this approach, as it avoids the necessity for a cautious taxpayer to declare multiple dividends rather than a simple dividend solely to avoid the risk of disallowance of even the portion of a dividend that was reinvested.

5. Acquisitions and Dispositions

Guidance is needed concerning the effect of acquisitions and dispositions on drafting and implementation of a DRIP.

Example. US group A is preparing to adopt a DRIP for its 2005 year. US group B has agreed to purchase US group A, subject to regulatory approvals, with the transaction expected to close during its 2006 tax year. As a result of such acquisition, US group A would terminate and its members would become members of US group B. US group A would like to include in its DRIP (i) expenditures of members of US group A that would be made after (as well as before) the acquisition and (ii) expenditures planned by members of US group B for periods after the acquisition. Alternatively, US group B is planning to adopt a DRIP and would like to include planned expenditures of members of US group A that would be made after the acquisition.

Section 965(c)(5)(A) provides that all USSHs which are members of an affiliated group filing a consolidated return shall be treated as a single USSH for purposes of section 965. It seems reasonable and consistent with the purpose of the statute to construe this provision on an ambulatory basis for purposes of a DRIP, such that the relevant USSH may reflect changes in group ownership. We would not draw a distinction for this purpose between a situation in which the USSH is becoming a member of a new group (as is US group A in the example above) or is acquiring a target group (as is US group B in the example above). Thus, taxpayers should be permitted to reflect as planned uses in the drafting of a DRIP expenditures of a corporation that is anticipated to be, at the time the expenditure is to be made, a member of the same group as the USSH adopting the DRIP. In such a case, if such ownership condition in fact is satisfied, the expenditure would qualify. Accordingly, we recommend that guidance clarify that, in the

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80 The same issues would arise if the acquisition close after the adoption of the DRIP during the Election Year itself.

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example above, (i) expenditures of US group A pursuant to its plan are not affected by the acquisition and (ii) the DRIPs of US group A and US group B each could include post-acquisition expenditures of the other group.

A similar issue regarding a disposition may occur.

Example. US group A adopts a DRIP that contemplates investment of the distribution to expand a facility owned by US member X. Shortly after payment of the dividend, the decision is made to sell X, and the sale is completed prior to making a substantial portion of the expenditures.

We recommend that guidance clarify that post-sale (as well as pre-sale) expenditures made by X in such a case satisfy the requirement that the expenditures set forth in the DRIP be made by the taxpayer. Consideration also may be given to the allocation of responsibility for satisfaction of a DRIP when a controlled subsidiary is spun off.

VI. **Permitted Use of Repatriated Funds**

1. **Background**

Section 965(b)(4) provides that the section 965 DRD does not apply to any dividend-unless the amount of the dividend is invested in the United States pursuant to a domestic reinvestment plan which –

(A) is approved by the taxpayer’s president, chief executive officer, or comparable official before the payment of such dividend and subsequently approved by the taxpayer’s board of directors, management committee, executive committee, or similar body, and

(B) provides 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.\(^{81}\)

2. **General Comments on Non-Exclusive List of Permitted Uses; Meaning of “Financial Stabilization of the Corporation for the Purposes of Job Retention or Creation”**

The anchor of section 965(b)(4) is that the use of the funds constitutes a “reinvestment [by the USSH] in the United States.” Thus, there must be a reinvestment by the USSH and it must be in the United States. Payment of executive compensation is prohibited. The provision then identifies certain uses as permitted provided they satisfy those strictures.

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\(^{81}\) I.R.C. § 965(b)(4).
The list of identified permitted uses in section 965(b)(4)(B) begins with the word “including” and ends with the novel and vague phrase, “financial stabilization of the corporation for the purposes of job retention or creation.” The list is explicitly non-exclusive and thus may be considered a safe harbor.

We note that a difference between the Conference Report’s description of this provision and the Joint Committee’s earlier description suggests that the conferees did not intend a particularly broad interpretation of the test. The Joint Committee on Taxation’s description of the Chairman’s Mark for the Conference Committee states that “[t]his list of permitted uses is not exclusive, and it is intended that the concept of investment in the United States be construed broadly.” In the Conference Report, the paragraph in which that sentence appears is exactly identical to the corresponding paragraph in the Joint Committee description, except that the emphasized phrase is omitted (and the quoted sentence begins with the words “the conferees note that”). It is not completely clear whether the omission of the emphasized phrase should be interpreted as signaling a stepping back from the earlier language and endorsement of a more neutral approach.

3. Investments Need Not Be Incremental

It is unclear from the statutory language whether a USSH’s investment in the United States must be greater than it otherwise would have been if the USSH had not received an extraordinary dividend. Unlike the requirement that the dividend be extraordinary (i.e., exceed the Dividend Threshold), and unlike the incremental test for related party indebtedness, there is no explicit requirement in section 965 that the investment be extraordinary or exceed some base period investment amount.

Moreover, we note that an incremental investment standard was proposed in an amendment offered by Senators Breaux and Feinstein but (as part of a proposed amendment that included several other controversial proposals) was rejected (75 to 25). This amendment would have required the permitted expenditures to be incremental over the taxpayer’s historic spending in such areas, in addition to limiting more narrowly the use of funds and limiting implementation to a three-year timeframe). By taking an incremental approach, the Breaux-Feinstein amendment would have avoided the issue of tracing of the repatriated funds.

In light of this legislative history, and the negative inference created by the specific statutory tests for determining when dividends and related party loans are extraordinary for purposes of section 965, we agree with Notice 2005-10’s conclusion that taxpayers are not required to show that investments made with extraordinary dividends represent an incremental increase over prior investments, and that the fact that the expenditure may have been planned

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82 The list is preceded by the word “including”, which, when used in a definition under the Code, “shall not be deemed to exclude other things otherwise within the meaning of the term defined”. I.R.C. §7701(c).

83 Staff of the Joint Committee on Taxation, Description of the Chairman’s Mark for the Conference Committee on H.R. 4520 (October 4, 2004).


prior to the adoption of section 965 (or prior to the preparation of the DRIP) is irrelevant, as is
the fact that the expenditures may have been made in the Election Year prior to the adoption of
the plan. 86

4. Requirement to Segregate Repatriated Funds Prior to Domestic Reinvestment

Section 965(b)(4) states that the section 965 DRD “shall not apply to any dividend …
unless the amount of the dividend is invested in the United States” pursuant to a DRIP and the
DRIP must provide “for the reinvestment of such dividend in the United States.” The phrase
“the reinvestment of such dividend” could be read to require that the actual cash repatriated be
expended pursuant to the DRIP. A less literal reading, however, would be consistent with the
earlier reference to the “amount of the dividend” (if that phrase is read as equivalent to “amount
equal to the dividend”). Under that reading, only the amount of repatriated funds would need to
be linked with the approved domestic expenditures, and no specific segregation or matching of
the repatriated funds to the expenditures (or, apparently, away from nonpermitted expenditures)
would be required. We commend the IRS and Treasury for adopting this reading of the statute as
a general matter in Notice 2005-10 § 4.05.

This “no-segregation” approach appears to be consistent with the legislative history. We
note that the fungibility of cash was repeatedly referred to during congressional consideration of
the various repatriation proposals that eventually took the form of section 965. Proponents of
the legislation clearly understood and accepted that it would be burdensome to impose a requirement
that repatriated funds be segregated prior to use for desired expenditures. Opponents of the
measure cited the fungibility of money in arguing that even with such segregation it would be
impossible to ensure that repatriated funds were expended in ways that facilitated congressional
intent to stimulate the U.S. economy and argued for an incremental approach. The Senate
considered and rejected an amendment to the provision that would have placed a variety of
strictures on the use of repatriated funds, including an incremental approach (the so-called
Breaux-Feinstein amendment). 87

Notice 2005-10 § 4.05 states that the IRS may apply “greater scrutiny” to cases in which
the domestic reinvestment expenditures extend “over the course of many years” and the taxpayer
incurs non-permitted expenditures during the same period. The Notice suggests that a segregated
account “in the amount of the dividend proceeds” would be a positive factor in establishing
compliance with section 965(b)(4). This statement seems to, under such circumstances, reflect
an understandable discomfort with very long reinvestment schedules, though it is difficult to see
how as a practical matter a taxpayer would distinguish a project in which such tracing should
displace the general rule of nontracing. We construe “positive factor” as meaning that the mere
fact that the reinvestment period is very long would not be a problem, as long as the plan is a
good faith reasonable plan.

5. Comments on Specific Types of Permitted Uses

a. Reduction of Indebtedness

86 See Notice 2005-10 §§ 4.01, 4.05, 4.06.
87 See note 84 above.
General test

As noted above, section 965(b)(4)(B) lists acceptable domestic reinvestment uses, including “financial stabilization for the purposes of job retention or creation.” Notice 2005-10 § 5.05(a) provides that repayment of debt is generally considered a permitted investment if the debt repayment contributes to the financial stabilization of the taxpayer for purposes of job retention or creation. The repayment or acquisition of an obligation between members of the same consolidated group does not qualify.88

The Notice (§ 5.05) provides that financial stabilization “ordinarily” will be considered to result from debt repayment (which we read as in effect establishing a per se rule), because of the reduction in the debt to equity ratio and lower debt service. On the other hand, the Notice states that whether financial stabilization is “for the purposes of job retention or creation” is largely a matter of business judgment.

With regard to substantiation of the job retention-creation factor, the Notice provides:

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. In this regard, a plan developed by the taxpayer as part of its strategic planning process that evidences expected use of savings attributable to reduced debt service principally for expenditures incurred in connection with permitted investments is one method of demonstrating a purpose of job retention or creation in the United States because such expenditures likely would have direct or indirect positive effects on employment in the United States.

We support the basic test as stated, namely, that “the taxpayer’s reasonable business judgment” be that financial stabilization “will be a positive factor in its ability to retain or create jobs” in the United States. On the basis of this test, taxpayers should be permitted to utilize repatriated funds to repay debt even if they have no stated plan for spending any savings resulting from the debt paydown, so long as the reasonable belief standard is met.

We find the intent and effect of the sentence that follows this enunciation of the test to be unclear and troubling. The Notice states that “a plan” showing expected use of debt reduction savings for other section 965 permitted uses would be “one method of demonstrating” that the debt was paid down with a purpose of job retention or creation. In effect, the Notice suggests that a taxpayer consider adopting two plans, the DRIP, and then a second plan for whatever part of the DRIP involves “financial stabilization” expenditures. Under this approach, the implication is that the payment of debt would not by itself be a qualifying use but would be only a first step with a need to actually invest in permitted uses the funds that would have been used for debt service. No other method of demonstrating such purpose is provided in the Notice. A need for a

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88 We note, however, that, generally, expenditures are permitted investments only if made to unrelated parties, as provided in § 5.01(b) of the Notice, and recommend that the debt repayment rule be conformed.
second plan would impose an unnecessary burden on the taxpayer and we recommend that
Treasury and the IRS clarify that taxpayers need only demonstrate a reasonable belief that
financial stabilization would be a positive factor in job retention or creation. Although the
second plan may not involve the specific requirements applicable to the DRIP, it would
effectively impose on cautious taxpayers the need to find section 965 permitted investments
other than financial stabilization for the entire amount of the repatriated funds. We question
whether such a burden is consistent with Congressional intent.

The statutory linkage of “financial stabilization” to the concept of “job retention or
creation” is extremely difficult to reconcile with a specific enforcement policy. There is no
suggestion in the statute or legislative history that Congress intended for the IRS to trace
employment levels to measure actual job creation. Furthermore, measurement of job retention
would be virtually impossible, as it would require projections of employment levels in the
absence of the financial stabilization expenditure (and would require isolating a myriad of other
variables as well). At the same time, a use for financial stabilization was considered to be a use
independent of other permitted uses. Under these circumstances, a reasonable reading of the
statute is that Congress presumed both that debt reduction is financially stabilizing, and also that
financial stabilization would at least tend towards job creation. That is, Congress intended for
U.S companies to use their judgment as to the expenditures best suited to promote financial
growth and therefore, ultimately, job retention or creation. Senator Gordon Smith, one of the
primary sponsors of the provision, made explicit the linkage of debt repayment to financial
stabilization to job retention or creation when he argued that repayment of debt enhances a
company’s ability to create jobs in the future. That admittedly indirect linkage of permitted
expenditures to job creation was apparently sufficient in the minds of the drafters of section 965.
Furthermore, we believe that it would be very difficult to administer any other approach to
permitted domestic reinvestment without requiring opinions of investment bankers or economists
that are not generally a part of corporate planning. Accordingly, we support the reasonable
business judgment test in the Notice, but recommend elimination of any significance given to
uses of the debt service savings.

\[\text{ii. CFC Borrowing}\]

As stated previously, we understand that many distributions of foreign earnings during
the Election Year will be funded by new borrowings at the CFC level. As a result of such
borrowing and use of the repatriated funds to repay debt of the distributee USSH, the USSH and
the CFC together may be in the same net leverage position as before the transaction. Further, the
general creditors of USSH may be in a worse position as their claims would be structurally
subordinated to the new borrowing.

\[\text{89 When the Senate passed S. 1637, including the repatriation provisions, Senator Gordon Smith made the}
\text{following statement on the Senate floor:}\]

\[
\text{It is my understanding that the concept of financial stabilization, for this purpose, encompasses use of the}
\text{repatriated funds to repay debt of the U.S. parent corporation. Use of these funds to pay down debt is a}
\text{qualified use for purposes of the provision. In fact, debt repayment will strengthen U.S. corporate balance}
\text{sheets, which will improve a company’s ability to employ and hire workers.}
\]

April 19, 2005
So long as the CFC actually funds repayment of its indebtedness, however, there clearly has been an effective repatriation as required by the statute. Accordingly, we agree with the guidance in the Notice that a borrowing by a CFC to fund a dividend should not adversely impact a debt repayment purpose. We find no support for the proposition that a repatriation funded at the CFC level by third party indebtedness (or indebtedness of non-CFC foreign affiliate) is required to be invested in a manner different from repatriations funded otherwise. The statute is designed to trigger repatriations from CFCs that will be invested by the distributee USSH in the United States. Therefore, we believe the assets and operations of the CFC should be considered separately from the assets and operations of the USSH in determining whether an investment by the USSH has been properly invested in the United States (and, if required, has achieved financial stabilization of the USSH).

iii. Duration of U.S. Debt Reduction

A repayment of debt may or may not have the effect intended by Congress, i.e., to free up both cash and borrowing capacity for growth of business activity and employment in the United States. However, we do not believe the statute contemplates fixed time periods and a regulatory tracking regime to test for permanency of reduced debt levels. In situations in which debt reduction is a permitted use of repatriated funds, we believe the duration of that reduction generally should be of no significance provided the reduction is made in good faith and not as part of a plan to borrow replacement funds very shortly thereafter for impermissible uses.

Notice 2005-10 § 5.05 provides that debt repayment will not be a permitted use to the extent that (1) the taxpayer had a plan or intent, at the time of the repayment, to incur additional debt “on substantially the same terms,” and (2) the taxpayer in fact incurs such additional debt. This disregard of debt repayment as a permitted use where the repayment is transitory is an extremely narrow application of substance over form principles discussed in Rev. Rul. 89-73, which is cited by Notice 2005-10. In most cases, new debt could be incurred that is not on substantially the same terms. In any event, we interpret the Notice as providing that taxpayers may repay debt with the intention of utilizing the additional borrowing capacity when an opportunity that was not present when the debt was repaid presents itself. The intent to borrow again, perhaps even within a short period of time, should not by itself cause the debt repayment to fail the permitted use test, so long as the repayment of debt is not, in substance, transitory.

iv. Tax Liabilities

Notice 2005-10 § 6.08, specifies that payment of one type of liability – liabilities in respect of taxes -- can never qualify as a permitted expenditure. The apparent reason is that such payments are not considered an “investment” and do not relate directly to creating jobs. While it is difficult as a technical matter to distinguish such obligations from short-term debt obligations given that the rationale for debt reduction as a permitted use is that the financial condition of a taxpayer may be strengthened by reducing liabilities, we can appreciate that tax liabilities – even those representing a multi-year adjustment – have a flavor of an operating expense that does not increase the value of the enterprise.

b. Tort Liabilities
Notice 2005-10 does not address payment of tort liabilities as a permitted use of funds. However, the “Fact Sheet” released by the Department of the Treasury in conjunction with Notice 2005-10 stated as follows:

The investments addressed in the guidance are illustrative and the guidance is not intended to provide an exhaustive list. The notice does not specifically address expenditures for tort liabilities. The notice does provide general guidance that expenditure for financial stabilization for domestic job retention or creation is a permitted use, which could encompass payments to satisfy a company’s outstanding liabilities.

Apparently Treasury specifically contemplates that, under appropriate circumstances, payment of tort liabilities would serve the same financial stabilization/job retention-creation purpose as debt repayment.

Further, although tort liabilities are not explicitly provided for in Notice 2005-10, section 5.05(c) of the Notice provides for “other expenditures” that contribute to the financial stabilization of the taxpayer for purposes of job retention or creation. Under this subsection, the financial stabilization requirement will be met if the expenditure “reduces financial constraints on the taxpayer’s U.S. operations.” The job retention-creation requirement in this “other expenditure” context will be met under the same standard set forth in connection with debt repayment, i.e., “the taxpayer’s reasonable business judgment is that such reduction in financial constraints will be a positive factor in its ability to retain and create jobs in the United States.” As with debt repayment, the taxpayer’s business judgment is measured at the time the DRIP is approved by the taxpayer’s president, CEO, or comparable official.

We believe that satisfaction of tort liabilities would advance the policy objectives of the drafters of section 965 in the same manner as discussed above with respect to repayment of debt. The payment of these obligations may not represent an immediate productive investment (any more than a repayment of debt), but they do reflect the same balance sheet and cash flow enhancement associated with repayment of debt, and may in turn further the economic stimulus objective of the legislation. Accordingly, we recommend that future guidance further clarify that tort liability payments meeting the standards set forth in Notice 2005-10 § 5.05(c) may qualify as a permitted use.

c. Asset Purchases

Section 965(b)(4)(B) states that a DRIP that provides for the reinvestment of a dividend as a source for funding . . . infrastructure . . . [and] capital investments” will satisfy the reinvestment standard. Notice 2005-10 provides that “expenditures for infrastructure and capital investments include physical installations and facilities that support the taxpayer’s business and other assets integral to the conduct of a business, provided that the infrastructure and capital investments are located and used in the United States. Such expenditures also include payments for services performed in the United States that are related to, or provided in connection with, otherwise qualified infrastructure or capital investments described in” the Notice. The Notice further provides that infrastructure and capital investments include “plant, property and
equipment, communications and distribution systems, computer hardware and software, databases, and supporting equipment,” as well as improvements to these items. 90

We recommend that no minimum holding period be required for capital assets, but that, as with respect to debt repayments, an anti-abuse rule aimed at de minimis holding periods be considered. The term “investment” implies that a purchased capital asset will be held for a reasonable length of time, as determined by custom in the taxpayer’s industry and by the length of time required to generate a profit from the acquisition. Consistently with such rule, we assume that prompt resale is acceptable if there is an unexpected intervening cause.

Notice 2005-10 provides that if the infrastructure or capital investment is partly within and partly without the United States, the amount of the expenditures that constitutes a permitted investment with respect to such item is limited to amounts attributable to assets that are located and used in the United States. Similarly, if services related to, or provided in connection with, qualified infrastructure or capital investments are performed partly within and partly without the United States, the amount of the expenditure that constitutes a permitted investment shall be determined under the principles of section 1.861-4(b)(1). We support this approach as a reasonable interpretation of the statute’s emphasis on job creation and retention in the United States.

Notice 2005-10 §5.08 provides that expenditures to acquire the rights to intangible property, through purchase or license, are permitted investments to the extent the rights are used in the United States. This rule, which generally would be consistent with rules governing income from licenses of intangible property (section 861(a)(4)), is a reasonable approach in light of the language of the statute.

The place of use of marketing intangibles such as trademarks appears to be where use of the intangible is legally protected. 91 The place of use of manufacturing intangibles, however, is very unclear, even for the purpose of sourcing royalties.

Assume, for example, that the taxpayer purchases the right to use a patent. The taxpayer manufactures items in the United States using the patent and sells the items outside the United States (or vice versa). The manufacturing intangible might be legally protected in both the country of sale and the country of manufacture or in just one such country). Has the property been used inside or outside the United States or both? Further, the intangibles may not be licensed but instead their value may be derived from a higher sales price for goods.

We suggest that “use” should not depend, for this purpose, on where the patent is legally protected, since such standard may provide no basis or a misleading basis. Rather, we suggest that “use” should depend on the extent of the taxpayer’s activities. If the taxpayer licenses the patent and receives royalties, we believe that the place of use of the patent would be determined consistently with the place of use for purposes of sourcing income, which generally should be based on the location of the activities of the licensee. If the taxpayer uses the intangible directly and derives profit in the form of sales or service income, then the place of use should be

90 Notice 2005-10 § 5.03.
determined on the basis of the location of the activities giving rise to such income. Such activities could be measured by employee hours (to effectuate the statute’s focus on job creation and retention).

Alternatively, assume the taxpayer purchases the right to broadcast an event, and has its equipment in the United States but broadcasts into country X. We suggest that a similar analysis apply and that “use” be based on the level of the taxpayer’s activity in this case as well, because activity is one proxy for measuring job creation or retention.

We recommend that guidance be issued to provide explicit standards for certain types of assets.

d. Acquisition of Businesses or Business Entities

Notice 2005-10 provides that an investment in or acquisition of a business entity, regardless of whether the entity is domestic or foreign, would be a permitted investment in the United States to the extent of the percentage of the total value of the assets owned (directly or indirectly) by the entity that, if acquired directly, would be permitted investments as described in the Notice.\textsuperscript{92} Assets of an entity (including any lower-tier entity in which the 10% threshold is met) must be valued, using the same methodology under § 1.861-9T(g) (tax book value, alternative tax book value, or market value) that the taxpayer uses for purposes of allocating and apportioning interest expense for the tax year under section 864(e). Whether the assets are permitted investments or not, however, is made based on whether the assets are located and used within the United States, rather than on the basis of the source of the income they generate.

We believe that this is a sensible and administrable approach. The direct or indirect acquisition of an interest in a business entity is a permitted investment only if the taxpayer directly or indirectly owns an interest representing at least 10% of the value of such business entity after the acquisition (for purposes of making this determination, the rules under section 267(c) shall apply).\textsuperscript{93} We agree with this decision, because investments that are merely portfolio in nature should not qualify. We also agree with the Notice’s use of value rather than voting power as the criteria. The Notice further provides a de minimis rule, under which if a taxpayer acquires an interest in a business entity and more than 95% of the expenditure would be a permitted investment or a non-permitted investment, the entire acquisition shall be treated as a permitted investment or non-permitted investment, respectively.\textsuperscript{94}

Purchase of a U.S. business or business entity or entry into a joint venture seems to be clearly within the scope of a qualifying investment in the United States, even though it is hard to see how an acquisition would necessarily help create or retain jobs (unless the acquisition rescued a previously declining acquired company). Indeed, mergers and acquisitions frequently result in job loss. The Notice addresses this issue by requiring that, at the time the DRIP is approved by the appropriate corporate officer, “the taxpayer’s reasonable business judgment is

\textsuperscript{92} Notice 2005-10 § 5.06(a).
\textsuperscript{93} Id. § 5.06(a).
\textsuperscript{94} Id. § 5.06(b).
that the resulting financial stabilization will be a positive factor in its ability to retain and create jobs in the United States.” Further, an acquisition of a U.S. business results in a different owner but no overall increase in U.S. business assets, and if the purchase takes the form of shares of a U.S. corporation, actually results in a decrease in U.S. business assets. Nonetheless, it is hard to deny that at least certain such transactions were contemplated by the statutory reference to “capital investments.” We therefore agree with Notice 2005-10 in respect of these guidelines as described above.

A further issue is whether a distinction should be drawn based on whether the seller is a U.S. or foreign person. In general, we believe no distinction is appropriate. For example, if a U.S. business is purchased from a foreign corporation, while funds move to a foreign seller, the business moves to a domestic corporation. The one exception we would make is a situation involving a foreign seller of shares of a U.S. corporation, since in such case not only are the assets in U.S. corporate solution after the repatriation no higher than before but also the dividend funds would be paid to foreign persons. We would be inclined to apply this exception whenever an acquired corporation was majority owned (by value) by non-U.S. persons, with shares traded on a domestic exchange presumed to be owned by domestic persons.

e. Research and Development

According to section 965(b)(4)(B), research and development is an acceptable means of investing a dividend in the United States. The statute does not define “research and development” for this purpose. Notice 2005-10 § 5.04 provides that research and development is determined under the principles of Treasury Regulation section 1.174-2. The Notice further states that permitted investments include only such research and development (i) that is performed in the United States, and (ii) for which the taxpayer bears the cost (e.g., for which the taxpayer is not reimbursed by another party). Expenditures may be made to employees or to independent contractors (other than to a related party as defined in §5.01(b) of the Notice). For activities that occur partly within the United States and partly abroad, the principles of Treasury Regulation section 1.861-4(b)(1) are used to calculate how much of the cost is a permitted investment. We agree that these rules are generally clear and workable.

More generally, we agree with the approach taken in the Notice that the research and development category be approached from the standpoint of the research and development activities rather than from the standpoint of ownership or use of any intellectual property that may result. To the extent that any such property is used in the United States, it may separately qualify as a permitted investment under the capital investment and infrastructure category (regardless of where the research and development activities occur).
f. Non-executive Compensation and Pensions

We commend Treasury and the IRS for permitting funds to be used for the payment of wages or other non-executive compensation of employees or independent contractors working in the United States, assuming the use can be specified in the DRIP in a broad sense (e.g., by facility or project) and anticipated amount.\(^{95}\) Such work force can reasonably be assumed to be creating value for the USSH’s domestic business. The combination of domestic jobs and growth of the domestic business seems to fit the essence of the ultimate statutory objective.

The Notice also clarifies that the relevant workers need not technically be “employees,” which we think is a rational rule consistent with statutory intent.

Regarding pensions, the Notice specifies that funding “a qualified plan within the meaning of section 401(a)” is acceptable to the extent that the funding (i) corresponds to services performed in the United States, (ii) relates to existing or newly hired workers, and (iii) does not relate to covered executives. While this is welcome guidance, it leaves open the question of whether funding a non-qualified plan to the extent the same three criteria are met is a permitted investment.\(^{96}\) We recommend that future guidance confirm that funding a non-qualified plan would be a permitted investment under the Notice’s description of compensation.

As noted, compensation (including deferred compensation and pension contributions) constitutes a permitted investment only to the extent that it is attributable to activities performed in the United States. The Notice cross-references Treasury regulation section 1.861-4(b)(1) as a means of pro-rating the costs of services that “are performed partly within and partly without the United States.” In contrast, taxpayers may use a “reasonable method” to determine the amount of funding for a qualified plan that is attributable to services performed within the United States, and the amount of such funding attributable to non-executive compensation. While pro-rating and apportioning may become complex, we agree that it is consistent with the statutory emphasis on U.S. job creation and retention, and believe that these are administrable rules for taxpayers to apply.

Funding of a qualified plan also can qualify under the financial stabilization category as long as the taxpayer acts in “satisfaction of an obligation to fund a qualified plan…for the purposes of job retention or creation in the United States.”\(^{97}\) In such a case, the expenditure “ordinarily” is treated as contributing to financial stabilization. Such stabilization is, in turn, treated as “for the purposes of job retention or creation in the United States” if, at the time the DRIP is signed by the relevant corporate officer, “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.”\(^{98}\) In that case, the taxpayer need not prove or analyze the extent to which the qualified plan relates to services performed in the United States or to current as

\(^{95}\) Id. § 5.02.

\(^{96}\) Such amounts, of course, would have to satisfy certain conditions to avoid constructive receipt and meet the requirements of section 409A.

\(^{97}\) Notice 2005-10, § 5.05(b).

\(^{98}\) Id.
opposed to retired employees. We agree that a funding of a qualified plan should be permitted to qualify as financial stabilization on such less restrictive, basis if the job creation or retention criterion can be met.

We recommend, however, that future guidance clarify whether the prohibition on funding executive compensation (§ 6.02) is intended to apply even in the context of a financial stabilization use.

g. Worker Hiring and Training

If the taxpayer uses the extraordinary dividend to hire workers permanently on its U.S. payroll but who will work abroad for short periods, to send workers permanently on its U.S. payroll abroad for training, or to train workers permanently on its non-U.S. payroll in the United States, there may be some question whether the related expenditures are an appropriate use of funds repatriated pursuant to section 965. Clearly, defining “U.S. jobs” is difficult when workers perform services in multiple locations. Bringing skills back to the United States by training workers outside the United States, however, arguably lessens the need to outsource tasks and furthers the statutory purpose by promoting U.S. job retention or creation. Thus, we believe sending workers to attend a short-term training course outside the United States clearly should qualify. We are dubious, however, that expenditures for hiring workers who will spend substantial work time outside of the United States, or training non-U.S. employees in the United States, should qualify.

Notice 2005-10 does not address these fact patterns directly, other than stating that expenditures incurred in connection with the funding of worker hiring and training shall qualify only to the extent attributable to services performed by the workers within the United States.

h. Executive Compensation

Section 965(b)(4) provides that “executive compensation” is not an acceptable investment under a DRIP. Notice 2005-10 defines “executive compensation” as “compensation paid, directly or indirectly, by or on behalf of the taxpayer, to any employee or former employee, in exchange for services (past, present, or future) performed for the taxpayer,” if the employee is covered, or would be covered if the employer were an issuer, or is a past employee that at the time of employment was covered or would have been covered if the employer were an issuer, under section 16(a) of the Securities Exchange Act of 1934. The Notice further allows (without requiring) taxpayers to treat their 10 highest-wage employees for the last calendar year as being the employees who would be covered by section 16(a) of such Act if the employer were an issuer of equity securities to which such section refers.

We find this definition of “compensation” to be clear and workable. We note the decision, reflected at § 5.02 of the Notice, to require that an allocation of even contributions to qualified plans be made between amounts corresponding to covered executives and other amounts (though we would have not drawn that line in such context).

99 Id. § 6.02.
i. Dividends and Stock Redemptions

Notice 2005-10 § 6.04 provides that dividends and other distributions made by a USSH with respect to its stock are never a permitted use (though dividends and distributions made to another member of a consolidated group are disregarded). A similar rule applies to stock redemptions.\(^{100}\) We believe that this treatment is a reasonable construction of the statute.

VII. **Effect on Other Deductions**

Section 965(d)(2) denies any deduction for expenses that are “properly allocated and apportioned” to the deductible portion of a section 965 cash dividend. There is no further definition of expenses that will be disallowed in the statute. Several congressional colloquies, however, provide insight into the intent of the expense disallowance rule. For example, in a colloquy between Senators Smith and Grassley, Senator Grassley indicated that the intent of the provision is to disallow only deductions for expenses that relate directly to the generation of the dividend in question. Senator Grassley provided two examples of such directly related deductions, stewardship costs and directly related legal and accounting fees. The colloquy also indicates that “directly related” expenses do not include general and administrative costs not directly related to generating the dividend and indirect expenses such as research and development costs, interest, state and local income taxes, sales and marketing costs, depreciation, and amortization.

Section 2.7(D) of the Technical Corrections Bill would amend section 965(d)(2) by substituting the phrase “directly allocable” for the phrase “properly allocated and apportioned.” Uncertainty presently exists, however, as to when, and even if, the Technical Corrections Bill will be enacted. Such uncertainty raises the issue whether administrative guidance, which may be issued prior to further congressional consideration of the Technical Corrections Bill, should adopt the standard provided by the Technical Corrections Bill and as explained by the Congressional colloquies on the meaning of the phrase “properly allocated and apportioned.”

Although Congressional colloquies are not often an authoritative source of interpretation, we believe compelling reasons exist to adopt the Technical Corrections Bill’s language and the intent of the provision as explained by the colloquies. First, and foremost, we believe the language of section 965(d)(2) is vague and ambiguous regarding its intended scope. Second, there are four colloquies relating to this provision in which the Congressional managers of the American Jobs Creation Act participated, a fact that we interpret as demonstrating that the managers are aware of the language’s ambiguity and the need to provide more definitive guidance. Third, the Technical Corrections Bill language is consistent and close in time to the colloquies. Fourth, in a recent letter, the leadership of the House Ways and Means Committee and Senate Finance Committee in effect directed Treasury to reflect the proposed standard in guidance.\(^{101}\) Finally, the brevity of the opportunity for taxpayers to avail themselves of section

\(^{100}\) Id. § 6.05.

\(^{101}\) Letter dated March 17, 2005 from William M. Thomas, Chairman, House Committee on Ways and Means, Charles E. Grassley, Chairman, Senate Committee on Finance, and Max Baucus, Ranking Member, Senate Committee on Finance, to Eric Solomon, Acting Deputy Assistant Secretary (Tax Policy), Treasury Department.
965 strongly suggests that administrative guidance be provided even prior to the enactment of the Technical Corrections Bill. Based on these factors, we believe that administrative guidance should be issued as soon as possible reflecting the Technical Corrections Bill and the colloquies.

Even under the standard of the Technical Corrections Bill and the colloquies, an important threshold issue remains regarding the appropriate method of allocation of expenses for section 965(d)(2) purposes. Various Code provisions provide methods of allocation for different purposes. Neither the statute nor the legislative history provides guidance as to which method should be applied or if another method unique to section 965 should be developed through administrative guidance. In general, we believe that the section 864(e) regulations may be an appropriate starting point. Although these regulations are concerned with expenses that are “definitely related” to a class of gross income, we consider those regulations, which consider deductions allocable to a class of gross income if incurred “as a result of, or incident to an activity or in connection with property from which such class is derived,” to provide guidance appropriate under section 965.102

Further, we note that Treas. Reg. §1.861-8(e)(4) and (5) are consistent with the colloquies described previously. Treas. Reg. §1.861-8(e)(4) provides that services undertaken by a corporation for a related corporation that are of a “stewardship” or “overseeing” nature should be treated as definitively related to the cash dividend received from the related corporation. For this purpose, stewardship activities generally represent a duplication of services, which the related corporation would independently perform for itself, and the deductions resulting from stewardship are incurred as a result of, or incident to, the ownership of the related corporation. Thus, the deductions are treated under the regulations as definitively related and allocable to the dividends received from the related corporation. Similarly, Treas. Reg. §1.861-8(e)(5) provides that legal and accounting fees are ordinarily definitively related and allocable to specific classes of gross income or to all the taxpayer’s gross income depending on the nature of the services rendered.

We believe it will be critical for guidance to provide examples of the factual relationship required between expenses and Election Year distributions to cause such expenses to be nondeductible, especially in the case of legal, tax and accounting fees and expenses. For example, expenses incurred by a USSH to determine the earnings and profits of a CFC are necessary to prepare annual tax filings as well as to determine whether a repatriation constitutes a taxable dividend qualifying for the section 965 DRD. We assume that such expenses incurred during the Election Year are not automatically disallowed, because they facilitate computation of taxable dividends qualifying for the section 965 DRD, and recommend that only the incremental cost be disallowed.

We note that in many cases it may be determined that expenses are properly allocable to all Election Year distributions (i.e., including distributions out of PTI, taxable dividends satisfying the Dividend Threshold, and further taxable dividends). In such cases, we believe it would be appropriate simply to disallow a proportionate part of such expenses generally based upon the amount of the section 965 DRD, over the total amount of Election Year distributions. Although once the standard for allocating deductions is determined, the mathematical process by

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which such identified deductions are denied may appear to be obvious, we nonetheless suggest that examples confirm the results in standard situations. Finally, we believe guidance should confirm that the deductibility of expenses properly incurred by a CFC is not affected by section 965(d)(2) (for purposes of computing the CFC’s earnings and profits).

VIII. Foreign Tax Credit Effects

Section 965 contains special rules concerning the application of the foreign tax credit rules with respect to foreign income taxes paid or accrued in connection with CFC dividends qualifying for the section 965 DRD. Section 965(d)(1) provides that no foreign tax credit shall be allowed for any taxes paid or accrued (or treated as paid or accrued) with respect to the deductible portion of any dividend or the Subpart F income inclusion described in section 965(a)(2). In addition, no deduction is allowed for such taxes.

Section 965(e)(1) generally prevents the use of credits to reduce U.S. federal income tax that would be due on “nondeductible CFC dividends” as defined in section 965(e)(3), i.e., 15% of the eligible section 965(a) dividends. Nevertheless, section 965(e)(1) allows for the use of foreign tax credits to reduce the amount of U.S. federal income tax due on the nondeductible CFC dividends. The Technical Corrections Bill would provide that foreign taxes paid or accrued which are not attributable to the section 965(a) eligible dividends cannot be used to reduce the tax on the nondeductible portion of the dividends, i.e., no cross-crediting would be allowed. The Technical Corrections Bill also would provide that the section 78 gross-up would not apply with respect to the foreign tax credits disallowed as a credit under section 965(d).

Taking into account the provisions in the Technical Corrections Bill, which we believe would be appropriate even in guidance preceding its further consideration and enactment, direct foreign taxes and indirect foreign taxes attributable to the nondeductible CFC dividends may be claimed as foreign tax credits against U.S. federal income tax on the nondeductible CFC dividends, but no other foreign tax credits may be used to reduce such taxes. Direct and indirect taxes associated with deductible CFC dividends may never be claimed as a deduction or credit. The amount of indirect taxes associated with the nondeductible CFC dividends are included in income under section 78, and the amount of deemed paid taxes associated with the deductible CFC dividends are not included in income.

Guidance is necessary to provide taxpayers with rules for specifying which dividends will be considered as eligible dividends for purposes of applying the foreign tax credit limitation. Again, only dividends in excess of the Dividend Threshold, and not in excess of the Ceiling Limitation (and limited by the related party indebtedness rule), are eligible for the Section 965 DRD. Thus, in the Election Year, a taxpayer may receive: (1) dividends that satisfy the Dividend Threshold, (2) dividends that are eligible for the Section 965 DRD, and (3) dividends in excess of the Ceiling Limitation. For this purpose, a taxpayer may specifically identify which dividends are used to satisfy the Dividend Threshold and which dividends are eligible for the

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103 See also letter dated March 17, 2005 from William M. Thomas, Chairman, House Committee on Ways and Means, Charles E. Grassley, Chairman, Senate Committee on Finance, and Max Baucus, Ranking Member, Senate Committee on Finance, to Eric Solomon, Acting Deputy Assistant Secretary (Tax Policy), Treasury Department.
Section 965 DRD.\(^{104}\) If a taxpayer fails to make such a specific identification, then a pro rata amount of foreign tax credits is disallowed for all dividends repatriated during the taxable year.\(^{105}\) The designation of which dividends, or portion of dividends, that are considered as eligible dividends should be permitted to be made by filing a tax return on the basis of such selection (similar to the election to claim foreign tax credits).

An example may be used to provide the necessary guidance illustrating the ability of taxpayers to choose which dividends will be treated as the section 965(a)(1) eligible dividends. For example, many taxpayers may receive dividends from several CFCs paid at different times during the Election Year. The example should show that a taxpayer may select only a portion of a particular dividend on which to claim the section 965 DRD, with the remaining portion satisfying the Dividend Threshold or merely being treated as a taxable dividend. Any administrative guidance issued should reflect the flexibility intended by Congress that a taxpayer be entitled to specifically identify which dividends satisfy the Dividend Threshold and which dividends qualify for the section 965 DRD.

The following is an example that might be included in administrative guidance to illustrate the flexibility of a taxpayer to designate the treatment of dividends for purposes of section 965:

Example. Assume that Taxpayer wholly owns CFC1, CFC2 and CFC3. Those CFCs have general limitation basket earnings and profits with associated foreign tax credit pools carrying an effective tax rate of 40%, 25% and 5%, respectively. Taxpayer has a Dividend Threshold of $180.

In 2005, Taxpayer receives aggregate cash dividends totaling $895--$120 from CFC1, $300 from CFC2, and $475 from CFC3. In order to use its foreign tax credits efficiently, Taxpayer desires that all of the dividends received from CFC1 apply toward satisfaction of its Dividend Threshold, i.e., $120 with $80 of section 78 gross-up (total of $200 included in income). Taxpayer desires that the remaining portion of its Dividend Threshold be satisfied with a portion of the dividend received from CFC2, i.e., $60 with a $20 gross-up amount (total of $80 included income).\(^{106}\) On these facts, there would be $2 of excess foreign tax credits associated with the Dividend Threshold amount ($100 – (35% x 280)).

The remaining portion of the CFC2 dividend of $240 and the entire $475 of the CFC3 dividend qualify as eligible dividends for purposes of section 965(a), or a total of $715. The gross-up that accompanies that amount would be $105 (i.e., $80 with the CFC2 dividend and $25 with the CFC3 dividend). Of the dividend amount, $107 (15% x $715) and the gross-up amount of $16 ($105 x 15%) is included in income, for a total of $123. The federal income tax on the $107

\(^{104}\) It appears, however, that a taxpayer would not be permitted to treat the dividend as allocable to a particular section 904(d) separate limitation category but rather that the normal pro rata rule would apply.

\(^{105}\) I.R.C. § 965(d)(3).

\(^{106}\) The gross-up amounts do not count toward satisfaction of the Dividend Threshold.
nondeductible portion of the dividend may be reduced by the $16 of related
deemed paid tax credits.

The dividends designated as satisfying the Dividend Threshold would be treated
as general basket income and the associated foreign taxes may be used to reduce
the U.S. taxes on such income (although the $2 of excess foreign tax credits may
not be used to reduce U.S. tax on the nondeductible CFC dividends).

The above example raises an issue related to the section 78 gross-up with respect to
deemed paid credits associated with the nondeductible CFC dividends (under the Technical
Corrections Bill there is no gross-up for deemed paid taxes with respect to the deductible
dividends). The amount of such gross-up is not part of the nondeductible CFC dividends, as it is
expressly excluded from the definition of dividends for purposes of section 965. In addition, it
can be argued that federal income tax due on this gross-up should be treated as “tax . . . by
reason of nondeductible CFC dividends” under section 965(e) (providing a limitation on the use
of foreign tax credits). The Technical Corrections Bill does not address this point. Nonetheless,
since the foreign tax credits giving rise to the gross-up are used to offset tax on the nondeductible
CFC dividends, we recommend that guidance confirm that such gross-up should be included
with that amount for purposes of applying the foreign tax credit limitation under section 965(e).

Example. Assume taxpayer receives $800 of extraordinary dividends from CFCs.
Assume $200 of deemed-paid credits accompany the dividends, and there are no
withholding taxes. Under 965, only $120 (15%) of the $800 is included in
taxpayer’s income. This would bear U.S. tax of $42. Only $30 of FTCs can be
claimed, since the $170 (85%) associated with the deductible CFC dividends is
not creditable. Taxpayer must include $30 in its gross income under section 78
(and not, under the Technical Corrections bill, the entire $200).

The issue is whether the tax on the $30 gross up may be reduced by other credits.
If “by reason of” in section 965(e) is construed narrowly, U.S. tax on the 30
would not be considered imposed “by reason of” the $120 nondeductible
dividend, and so foreign taxes in the general limit basket would be available as
credits against the U.S. tax on the 30 gross-up income. We believe that this result
was not intended, however, and that a more appropriate approach is that the $30
should be treated in the same manner as (in effect, added to) the $120 of
nondeductible CFC dividends, and U.S. tax on the $150 total ($52.50) only
permitted to be reduced by the $30 credit to $22.50, with no other foreign tax
credits permitted to be used against the remaining tax liability under section
965(e).

Another issue related to the use of foreign tax credits under section 965 stems from the
fact that section 965 does not explicitly provide that, for section 904 purposes, foreign source net
operating losses (“NOLs”) carried to the year of a section 965 dividend are not applied against
the 15% non-deductible portion of the section 965(a) eligible dividend.\(^{107}\) If the NOLs in fact are

\(^{107}\) Section 965(e)(2)(A) refers to “taxable income,” which also is a term used in section 904(a) and on that basis
even without clarification the provision as written could be construed as applicable to section 904.
applied for such purposes, that amount subsequently may be characterized as domestic source income, leaving the associated foreign taxes trapped. In addition, overall foreign losses ("OFLs") from the general basket may reduce the amount of foreign source income (and the OFLs would correspondingly be reduced). Such a regime would not seem to be consistent with the prohibition against cross-crediting. Thus, we recommend that administrative guidance make it clear that the 15% nondeductible portion of the section 965(a) eligible dividend is not reduced by foreign source NOLs for section 904 purposes just as it is not for taxable income purposes generally, and that such nondeductible portion is not subject to general basket OFLs, if any.

One approach that would address the section 78 gross-up issue and the section 904 sourcing issues related to the nondeductible portion of CFC 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 credits that may be applied against the 15% nondeductible portion of the section 965(a) eligible dividend. We recognize that such an approach may require a legislative change as part of the Technical Corrections Bill or Treasury might be able to use its regulatory authority to interpret language in the Conference Report that "[t]he deduction itself will have the effect of appropriately reducing the taxpayer’s foreign tax credit limitation."  

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