GECC subsidiaries should have been treated as an allocation of income. The court stated that investment in capital is only a factor in determining the partners' interests in the partnership, and found that the economic reality of the allocations resulted in the "unambiguous assignment" of 98% interest of the operating income of the partnership to the Dutch banks.[12] Thus, the court found that the allocations of income had substantial economic effect.

COLTEC AND BLACK & DECKER

Coltec and *Black & Decker* involved transactions in which the taxpayers sought to isolate contingent liabilities (asbestos litigation claims in *Coltec* and employee healthcare claims in *Black & Decker*) from other company assets. In each case, the taxpayer contributed assets to a corporation subject to the contingent liability. While the contingent liability reduced the fair market value of the stock received by the taxpayers, such contingent liability was not treated as a liability for purposes of sections 357 or 358. Thus, the liability would not reduce the basis of the stock received by the taxpayers. In each case, each taxpayer later sold the high basis, low value stock for a substantial capital loss and utilized such loss to offset capital gains.

The IRS argued that the transactions in *Coltec* and *Black & Decker* did not have economic substance. Unlike the Connecticut District Court in *Castle Harbour*, which did not address the issue of whether the legal sham test is a disjunctive or a conjunctive test, the Maryland District Court in *Black & Decker*, and the Court of Federal Claims in *Coltec* did address this question. Both the Maryland district court and the Court of Federal Claims analyzed each respective transaction under the disjunctive test. In *Black & Decker*, the court noted that, although the taxpayer conceded for purposes of summary judgment that tax avoidance was its sole motivation for structuring the transaction as it did, the corporation engaged in bona fide economically-based business transactions and therefore had economic substance. Quoting *Rice's Toyota World*, the court stated that it could not ignore a transaction that had economic substance, even if the motive for the transaction was to avoid taxes.[13] In *Coltec*, in finding that the taxpayer had satisfied both the business purpose and economic effect prongs, the court stated that the economic substance doctrine is satisfied upon the satisfaction of "at least" one prong of the two-prong test.[14] Notably, in both *Coltec* and *Castle Harbour*, the courts indicated that Congress, rather than the judicial branch, had the responsibility for establishing the law on what constitutes economic substance.

CONCLUSION

As mentioned above, it remains to be seen exactly what impact these decisions will have, as well as whether the decisions will be affirmed on appeal. However these cases are ultimately resolved, the guidance that such resolution will provide will be eagerly anticipated by tax practitioners.

A **TAX HOLIDAY** FOR REPATRIATED FOREIGN EARNINGS: NEW SECTION 965

by Michael E. Steinsaltz, Philadelphia, PA

INTRODUCTION

On October 22, 2004, the President signed the American Jobs Creation Act of 2004 ("Act"), which contains the most comprehensive international tax reform since the Tax Reform Act of 1986. This Point discusses one of the most important and highly anticipated provisions of the Act: new section 965, which, for a limited time, provides very favorable tax treatment for repatriated foreign earnings.

Section 965 allows for a one-year 85 % dividends received deduction ("DRD") for certain cash dividends received by U.S. shareholders from controlled foreign corporations ("CFCs"). The deduction will make it possible for many taxpayers to repatriate foreign earnings at a much lower tax cost than would be possible under current law. If several technical issues with the Act are resolved favorably for taxpayers, effective tax rate on dividend distributions under section 965 will be 5.25%.[1]

Not surprisingly, some limitations apply. The DRD is limited to the excess of all current year dividends from CFCs over a base period amount ("extraordinary dividend limitation") and is capped at the greater of $500 million or the amount of permanently reinvested earnings shown on the taxpayer's most recent financial statements certified on or before June 30, 2003. The new provision also restricts how such dividends can be financed ("related party indebtedness rule") and how the cash received by U.S. shareholders must be used ("domestic reinvestment plan"). It also disallows foreign tax credits and allocable expenses to the extent that they relate to the deductible portion of the dividends. The effective date is, at the taxpayer's election, either the last taxable year that begins before the date of enactment, or the first taxable year that begins during the one-year period beginning on the date of enactment.

Because the new provision can be so beneficial to so many taxpayers and because it is of limited duration, it is important to begin planning immediately. Optimizing the planning opportunities under section 965 requires an examination of some of the questions raised by the provision. This Point will identify those questions and discuss likely appropriate responses.

12 *Castle Harbour*, supra, n. 2, at 80.

13 *Black & Decker*, supra, n. 3 at 7.

14 *Coltec Industries*, supra, n. 4 at 128.

1 On Friday, November 19, 2004, a Technical Corrections Bill (the "Bill") was introduced into the House of Representatives. The Bill addresses several key issues identified in this Point. As of the date of publication, the technical corrections contained in the Bill have not been enacted into law. Nevertheless, where relevant, the impact of the Bill is noted.

CASH DIVIDEND

Although the section 965(a)(1) DRD is only available for "cash dividends," section 965 does not affirmatively define the term "dividend". Nevertheless, section 965(c)(3) provides that the term "dividend" shall not include amounts includible in gross income as dividends under sections 78, 367, or 1248, and the Conference Committee Report ("Conference Report") explains that the deduction applies "only to cash dividends and other cash amounts included in gross income as dividends, such as cash amounts treated as dividends under sections 302 or 304 (but not amounts treated as dividends under sections 78, 367, or 1248)." Although sometimes thought of as deemed dividends, amounts included in a taxpayer's gross income under subpart F and section 956 are not technically dividends under Section 316. Thus, subpart F and section 956 inclusions are not generally eligible for benefits under section 965.

Section 965(a)(2) expands the definition of a cash dividend to include certain election year cash distributions that are excluded from gross income as previously taxed income ("PTI") under section 959(a). The PTI exception applies to the extent that the subpart F income that created the PTI results from the payment of a dividend by one CFC to another CFC (i.e., a dividend treated as foreign personal holding company income under section 954(c)(1)(A)) with the result that the cash travels through a chain of CFCs to the taxpayer within the election period. This provision allows dividends to be paid through multiple tiers of CFCs.

On January 10, 2005, the Treasury Department and the Service issued Notice 2005-10 ("Notice") providing guidance on new section 965. The Notice addresses the meaning of the term "cash dividends." It provides rules regarding the treatment of foreign currency and cash equivalents as cash, and how to treat cash dividends received by pass-through entities such as disregarded entities and partnerships. The Notice also addresses whether the amount of a cash dividend is reduced by expenses or deductions of the taxpayer related to such cash dividend, including foreign withholding tax and U.S. federal, state or local income tax imposed thereon.

EXTRAORDINARY DIVIDEND LIMITATION

Section 965(b)(2) limits the amount of dividends that can be taken into account under section 965(a) to the excess of:

(a) Dividends[2] received during the taxable year by shareholders from CFCs; over

(b) The annual average for the base period years of dividends, section 956 inclusions, and distributions of PTI (other than distributions attributable to prior taxable year section 956 inclusions) (collectively referred to as "annual amounts").

The average of the annual amounts is referred to as the "base period amount." Base period years are comprised of the five taxable years ending on or before June 30, 2003 disregarding the taxable years with the highest and lowest annual amounts. The annual amounts are determined based on amounts shown on the most recent return filed for each base period year, except that amended returns filed after June 30, 2003 are not taken into account.

If a taxpayer has fewer than five taxable years ending on or before June 30, 2003, then the base period includes all taxable years of the taxpayer ending on or before June 30, 2003. The average annual amount is adjusted for certain mergers, acquisitions, spin-offs and other dispositions.

RELATED PARTY INDEBTEDNESS

The related party indebtedness rule of section 965(b)(3) may prove to be one of the most challenging elements of section 965. Section 965(b)(3) provides that the amount of dividends eligible for the DRD must be reduced by the increase in related party indebtedness of the taxpayer's CFC from October 3, 2004, until the close of the tax year for which the taxpayer elects to apply section 965. For purposes of this limitation, the taxpayer must treat all CFCs for which it is a U.S. shareholder as a single CFC. According to the Conference Report, this rule is intended to prevent a taxpayer from claiming the DRD in cases in which the taxpayer itself directly or indirectly finances the payment of a dividend from a CFC. In such a case, the Conference Report states, "there may be no net repatriation of funds, and thus it would be inappropriate to provide the deduction."

The related party indebtedness rule prohibits a taxpayer or non-CFC related party from lending funds to one or more CFCs to finance a distribution of earnings. This restriction is relevant where the distributing CFC does not have cash on hand to pay the dividend. It also prohibits a CFC from distributing a note to the taxpayer rather than cash. Perhaps most importantly, the related party indebtedness rule may be a trap for taxpayers that increase lending to one or more CFCs for purposes other than to finance a dividend distribution. For example, the rule appears to apply to a loan from a taxpayer to a CFC to finance an acquisition by the CFC or to satisfy increased working capital requirements of the CFC. The related party indebtedness rule does not prohibit lending from one CFC to another to finance a distribution from such CFC because all CFCs are treated as a single CFC under the rule.

The reference to "net repatriation of funds" in the Conference Report raises the specter that transactions not covered by the literal language of section 965(b)(3) but do not in substance amount to a net repatriation of funds to the U.S. could also be challenged by the Service.[3] For example, this language

2 The Bill adds the word "cash" before the word "dividends." Thus, if enacted, the Bill would deny a taxpayer the ability to satisfy the base period amount with non-cash dividends.

3 The Bill provides the Secretary with regulatory authority as may be necessary to prevent the avoidance of the related party indebtedness rule, including authority to promulgate regulations which provide that "cash dividends" would not be taken into account under section 965(a) "to the extent such dividends are attributable to the direct or indirect transfer (including through the use of intervening entities or capital contributions) of cash or other property from a related person to a CFC."

could bolster a challenge by the Service under existing circular cash flow, substance over form, and sham transaction principles. Despite this language, third party borrowing (including borrowing guaranteed by the taxpayer) to finance DRD eligible dividends under section 965 appears to be permitted so long as the CFC that purports to be the borrower is treated as such under general U.S. tax principles (see e.g., Plantation Patterns v. Commissioner, 462 F.2d 712 (5th Cir.), cert denied 409 U.S. 1076 (1972)). Thus, taxpayers that need to finance dividends to obtain maximum benefit under section 965 should carefully plan how such financing will be structured.

DOMESTIC REINVESTMENT

The section 965 DRD only applies to dividends invested in the U.S. pursuant to a domestic reinvestment plan. Such a plan must be approved by the taxpayer's president, CEO, or comparable officer before the dividend is paid and must subsequently be approved by the taxpayer's board of directors, management committee, executive committee, or similar body. The plan must provide for the reinvestment of the dividends in the U.S. Although the dividends cannot be used for the payment of executive compensation, they may be used 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. This list of permissible uses for the dividends is not exclusive. The Chairman's Mark indicated that concept of reinvestment in the U.S. should be construed broadly, but the final Conference Report dropped that language without explanation. The domestic reinvestment plan need not apply to dividends for which the DRD is not being claimed.

In addition to grappling with the related party indebtedness rule, taxpayers will likely find it challenging to ensure that they have satisfied the requirements of a valid domestic reinvestment. The description of eligible uses for the dividends is open to significant interpretation. Questions include: how will a taxpayer demonstrate that the dividend was used to hire or train workers, build infrastructure, conduct research, etc? Must the activities undertaken pursuant to the plan be incremental? How expansive is the "financial stabilization" language? If the list of cash uses is not exclusive, what other forms of reinvestment will qualify and how will taxpayers document such uses?

The Notice provides answers to many of these important questions. It provides general guidance concerning domestic reinvestment plans, lists certain expenditures that, if made pursuant to a domestic reinvestment plan, are investments in the U.S., and lists certain expenditures that are not permitted investments. The Notice also provides guidance on reporting requirements and on how a taxpayer may, under the facts and circumstances, establish to the satisfaction of the Commissioner that the dividend proceeds are invested in the U.S. pursuant to a domestic reinvestment plan, including a safe harbor for making such a demonstration.

CREDIT AND EXPENSE DISALLOWANCE

Section 965(d)(1) provides that no foreign tax credits or deductions for foreign taxes are allowed for any taxes paid or accrued (or treated as paid or accrued) with respect to the deductible portion of any dividend or PTI distribution. Interestingly, section 965 does not provide for the elimination of the section 78 gross-up related to such non-creditable and non-deductible foreign taxes. Under the literal language of section 965, foreign taxes related to deductible dividends appear to be included in gross income without the benefit of an offsetting credit or deduction. Many tax professionals believe that this is an unintended drafting error and hope for a technical correction or for regulatory guidance that would alleviate the negative consequences of this provision by excluding from gross income foreign taxes that are disallowed under section 965(d)(1) or by permitting a deduction for such taxes to offset the section 78 gross-up which they generate.[4]

The disallowance of foreign tax credits related to the deductible portion of any dividend or PTI distribution means that taxpayers will want the flexibility to choose which cash dividends are used to satisfy the base period amount (if any) and which are entitled to a DRD under section 965. This flexibility is important because taxpayers will want to specify that high tax dividends are allocated to the base period amount and low tax dividends are allocated to the section 965(a) amount eligible for the DRD. The Conference Report provides that taxpayers may specifically identify which dividends are treated as carrying the deduction and which are not.

Section 965(d)(2) provides that no deduction shall be allowed for expenses properly allocated and apportioned to the deductible portion of any cash dividend. This language would normally connote broad expense allocation principles such as those contained in section 861 and Treas. Reg. § 1.861-8. However, in each of the House and Senate colloquies, Rep. Thomas and Senator Grassley indicated that their intent was for narrow expense allocation. They each stated that the "intent of the rule is to disallow only deductions for expenses that relate directly to generating the dividend income in question." Senator Grassley further stated that "related expenses would include, but is not limited to, stewardship costs and directly related legal and accounting fees." Despite these statements, the application of the expense disallowance rule remains unclear, at least until the Service issues guidance on the matter.[5]

4 The Bill does provide for the elimination of the section 78 gross-up on taxes that are non-creditable pursuant to section 965.

5 The Bill changes the phrase "properly allocated and apportioned" to "directly allocable." This appears to be a narrowing of the expense disallowance provision of section 965.

CONCLUSION

Section 965 gives taxpayers a unique, one-time opportunity to repatriate earnings from CFCs at a significantly reduced tax cost. Taxpayers should begin now to plan for the many issues that will arise in developing a repatriation plan so that they secure the benefit of section 965 with a manageable level of risk.

BUYING REAL ESTATE THROUGH IRAS AND QUALIFIED PLANS

by Alexander Drapatsky, Chicago, IL

Clients looking for sources of investment capital often overlook the obvious. As the life expectancies and retirement ages of Americans increase, the amount of assets they own through IRAs and qualified plans ("Retirement Plan Assets") have increased as well. Most clients think of mutual funds, equities and debt instruments as appropriate assets to hold in retirement accounts. However, more clients are using "non-traditional" investments, including investments in start-up businesses and investment real estate, as Retirement Plan Assets.

IRA AND PLAN CONTRIBUTION LIMITS

The 2001 Economic Growth and Tax Relief Reconciliation Act increased the maximum amounts individuals may contribute to IRAs and qualified plans. In 2005-07, individuals may contribute up to $4,000 to an IRA per year. This amount will increase to $5,000 in 2008, and will be indexed for inflation thereafter. Participants in employer sponsored qualified plans may contribute and/or receive employer contributions of up to $40,000 per year. Moreover, individuals age 50 or older may contribute to IRAs and employer sponsored plans additional amounts in excess of the basic annual contributions.

The growth in Retirement Plan Assets has also increased because many taxpayers who departed employers that sponsored qualified plans have rolled-over their Retirement Plan Assets into IRAs. Such IRAs, unlike employer-sponsored plans, may be self-directed and assets held in them could also be made available for investment capital.

OPERATION OF SELF-DIRECTED IRAS

A self-directed IRA or retirement plan is one in which the account owner decides on the investments, which are not offered by the IRA custodian. Such self-directed plans contain investment language that permits account owners to direct the trustee or custodian of the plan to make any investment permitted by law. The plan documents must also state that the custodian will not allow transactions that the Code and ERISA prohibit with respect to Retirement Plan Assets.

A retirement plan account that does not violate the prohibited transaction rules discussed below can be used to invest in real estate, including vacant land, commercial buildings, rental properties, promissory notes, tax certificates, and even interests as tenants-in-common. Such accounts could also acquire real estate interests via private equity such as interests in limited partnerships, LLCs, and C corporations. A retirement plan account may hold real estate in conjunction with other owners, provided the deed or other ownership document clearly reflects the portion of the property owned by such account, and that such portion is an undivided interest. However, a disqualified person (discussed below) cannot own any portion of such real estate.

Real estate, as much as any investment asset, is generally subject to leverage. A retirement plan account investing in leveraged real estate may be subject to additional risks, including (1) whether the loan will constitute a prohibited transaction; and (2) whether the investment will expose the account to liability for unrelated business taxable income. Both are discussed immediately below.

PROHIBITED TRANSACTION RULES

Section 408(a) imposes specific requirements on IRAs, which if satisfied, will allow the assets in such accounts to grow tax-deferred. Such requirements include: (1) the IRA trust must be in writing; (2) the contribution limits must be stated in the trust document; (3) the IRA must be created or organized in the United States; (4) the trustee/custodian generally must be a financial institution, unless the trustee can demonstrate to the IRS that it is capable of administering an IRA; (5) the account must be created or established for the exclusive benefit of an individual or his beneficiaries; (6) the IRA agreement must prohibit investment in "life insurance contracts"; (7) the IRA agreement must provide that the assets of the trust or custodial account will not be commingled with other property, except in a common trust fund or common investment fund. Employer sponsored qualified plans must meet these and additional requirements in order to remain "qualified."

Even if a retirement plan account meets the foregoing statutory requirements to allow its assets to grow tax deferred, the Code prohibits certain transactions between an IRA and "disqualified persons." Similar rules apply to qualified plans. Section 4975(e)(2) defines a disqualified person as a fiduciary, plan service provider, plan sponsoring employer, majority equity owner, family member of an account owner, and officer, director or other employee of a business sponsoring such plan. If a prohibited transaction occurs between a disqualified person and a retirement account, excise taxes, income taxes and loss of the account's status as an IRA or qualified plan might result.

While the Code and ERISA do not state permissible retirement plan investments, these statutes do state what is prohibited (subject to numerous exceptions). Specifically, both the