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DOCUMENT NO.	FORM	SUBJECT/TITLE	PAGES	DATE	RESTRICTION(S)
001	Memorandum	Should the dividend repatriation holiday be extended? - To: Ben Bernanke - From: John Anderson, et al	1	10/28/2005	P5;
002	Handwritten Note	Jim Hines	1	10/25/2005	P5;
003	Handwritten Note	Greg	5	10/24/2005	P5; P6/b6;
004	Memorandum	Dividend Repatriation - To: Ben Bernanke - From: John Anderson	2	10/21/2005	P5;
005	Memorandum	Dividend Repatriation - To: Ben Bernanke - From: John Anderson	2	10/21/2005	P5;
006	Email	RE: repatriated profits tax holiday - To: Ben Bernanke, et al - From: Gary D. Blank	2	10/17/2005	P5;

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007	Memorandum	Territorial vs Worldwide Taxation of Corporate Income - To: Harvey Rosen - From: Jerry Auten, et al	2	N.D.	P5;
008	Memorandum	Dividend Repatriation - To: Ben Bernanke - From: John Anderson	1	10/21/2005	P5;

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International Income Taxation

By
Michael J. Graetz*

Much of what I will say here today is distilled from articles that I have written and things I have learned in putting together a book called FOUNDATIONS OF INTERNATIONAL TAXATION.[1]

It is difficult enough to fashion sensible tax policy in the domestic arena. The debate, for example, over whether the United States should impose a value-added tax has some international aspects, but it is primarily a debate about domestic policy. This is true generally about the debate over how much we should rely on income versus consumption taxation. This debate amply illustrates how hard it is to obtain agreement on principles when we have, what Fred Goldberg calls, one Caesar claiming the revenues. In international affairs, we have at least two Caesars—two national governments—with legitimate claims to tax the income. We must decide how to divide the tax dollars between the two Caesars. Multinational corporations strive to pay taxes to neither. Disputes are inevitable. It is therefore very important to think about the underlying principles of international taxation and to be explicit about what we are trying to achieve.

The Normative Underpinnings

Unfortunately and importantly, policymakers' longstanding understanding of the normative underpinnings of international tax policy is thoroughly unsatisfactory. I have made this point in detail elsewhere. The essential problem is that at least since 1962, when subpart F was enacted, the Treasury Department and the Joint Committee on Taxation have looked to capital export neutrality (CEN) and capital import neutrality (CIN) or "competitiveness" as a guide to U.S. international tax policy. It is now well known that we cannot have both CEN and CIN simultaneously whenever there are differences in the tax base or tax rates between two countries. What that means is that setting policy becomes free play. If the policy guideline is to compromise between CEN and CIN, that is no guideline at all. You can compromise anywhere.

Several of us have been recently searching for the proper guide to international tax policy. This is a very important quest. Whether Mihir's new idea of "capital ownership neutrality"[2] advances the ball sufficiently remains to be seen, but at least it's an admirable effort. I must, however, admit to some skepticism since this norm is grounded solely on worldwide economic efficiency.

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I believe, and I have written about this a good bit, that the fundamental question we ought to be asking is what policy is in the United States' national interest? What rules will best serve the long-term interests of the American people? That is the question we normally ask about other nontax international policies, and that is the basic question we ought to ask about international tax policy. There is no reason to depart here in favor of worldwide norms.

The great difficulty then becomes knowing what to do—the problem of empirical uncertainty. It is very difficult to get satisfactory information about the consequences of alternative policy decisions. Contested facts inevitably play an important role. For example, does foreign expansion by U.S. multinationals reduce or expand American jobs? We don't know with certainty the extent to which capital used abroad replaces capital that would otherwise be deployed in the United States, or whether instead the capital that is deployed abroad is complimentary to capital in the United States and will increase U.S. jobs. These are empirical questions. We need better information about them in order to make a firm judgment about international tax policies—for example, about the effect of substituting an exemption system for our credit system—on the welfare of the American people.

Looking to advance the well-being of the American people does not necessarily mean that we should always adopt policies advancing the competitiveness of U.S. multinationals. What is good for General Motors is not always good for Uncle Sugar. Advancing the competitive position of U.S. multinationals may or may not be the right answer, depending on the issue and the circumstances.

Taxing Business Income

We have talked here today a lot about taxing active business income and in particular about the debate between a credit system and an exemption system. I want to make a few comments about this. If you go back to the origins of U.S. international tax policy—and I think looking at this history is quite useful—you will discover that the foreign tax credit was not put into the Code to promote capital export neutrality. It was enacted for mercantilist reasons. It was the policy of the U.S. to encourage U.S. companies to go abroad and trade. The limitation on the foreign tax credit was put in the law a few years later to protect U.S. taxation of U.S. source income. An unlimited credit would allow taxpayers to escape U.S. tax on U.S. source income. The principle that T.S. Adams, who was the person who designed our foreign tax credit system, had in mind in the case of business income was that the prime claim between the two Caesars to the tax revenue is the claim of the country of source. Adams insisted that the country where the income is produced is the country in which income tax should be levied, and the country from which the capital is supplied should defer to the country where the income is produced. The primacy of source-based claims to income taxes on active business income has been a feature not only of the U.S. system, but of all OECD tax systems, since 1918. The other principle that motivated the system introduced in the United States in 1918 and 1921 and the League of Nation's model treaty in 1928 was that we should avoid double taxation. If the source country claims the tax on income, the residence country should not tax it again. T.S. Adams also thought that we should be worried about zero taxation.

The best empirical evidence to date suggests that most foreign active business activity is complimentary to U.S. business activities and not a substitute for it. This means that where active business income is involved, there is considerable evidence that the activities abroad of U.S. multinationals usually enhance U.S. welfare and promote U.S. jobs. There is more work to be done on this question, but producing abroad is often how U.S. companies exploit a whole host of advantages in terms of both proprietary intangibles and economies of scale and scope.

Given our system for taxing active business income, where we concede the primacy of source-based taxation, an exemption system and our credit system with deferral generally for active business income are not terribly far apart. One of the lessons of the work on exemption that Paul Oosterhuis and I did was to demonstrate how the two approaches are very close, although they differ in a few important respects.[3]

One major difference is that with an exemption system there is no cost for repatriations, for bringing money back to the home country. Under a credit system, there often is much tax planning, as everyone here knows well, to avoid incremental U.S. income tax when money is brought back into the United States. I believe the major advantage of an exemption system is to eliminate that burden.

I personally favor slightly an exemption system over our credit system, but there are questions that must be answered with an exemption system. Should we exempt all foreign source income or exempt only in-

come that has been previously taxed, and, if so, taxed at what rate? With exemption, we clearly would have to maintain a subpart F equivalent for passive income. That inevitably raises the questions, which we discussed here all morning, relating to the treatment of subpart F base-company income and the like.

One critical point is that U.S. businesses generally do not like an exemption system. You might think, given all the noise about international competitiveness, that U.S. businesses would embrace a system that would exempt their foreign business income from U.S. taxation. But they do not embrace it. The reason is that with an exemption system the United States would tax foreign source royalty income, which it does not now tax because in practice such income can be sheltered through the use of foreign tax credits. So the U.S. multinational community says, "Thank you very much, but we don't want it. Please don't exempt our income abroad."

The simplification advantages that are claimed for an exemption system are often overstated, particularly if Congress decreases the number of baskets for foreign tax credits from nine to two. We surely have a more complicated foreign tax credit system than we need. Thinking about an exemption system does point to some potential simplifications of the foreign tax credit, and decreasing the number of baskets is one of them, but I do not think that simplification is a good reason to move to an exemption system.

Taxing Portfolio Income

Another piece of the international tax puzzle is the taxation of portfolio income. I have recently written an article with Itai Grinberg on this subject.[4] The previous literature almost completely ignores portfolio income. Virtually all of the literature is about taxing business income.

The taxation of portfolio income was, after all, only a small consideration in 1918 and 1921. There were no doubt a few wealthy people who had some international portfolio income, but taxing business income drove the design of our system for taxing international income. The experts have not thought much about taxing portfolio income. The recent growth in international portfolio income, however, is very dramatic. The numbers are staggering regarding the international flows of portfolio income. We need to re-examine this issue.

Many of the features of direct investments are not present for portfolio income. In particular, neither capital export neutrality nor capital import neutrality are important, because portfolio investors do not decide the locations of plant or equipment. Capital ownership neutrality, to the extent I understand it, is also not relevant because it is concerned with the management of the firm and, therefore, addresses only direct investment. So none of the criteria we talk about most in international taxation apply to international portfolio income.

Portfolio income flows very differently from the way direct investments operate. Portfolio investments move much more rapidly. They leave when the milk becomes sour. We have seen this in the outflows prompted by the Mexican and Asian financial crises.

In my view, there is a strong argument for the primacy of residency-based taxation for foreign portfolio income. Otherwise, the residence nation loses the ability to tax people on their ability to pay if residents can avoid progressive taxation simply by moving their portfolio income abroad. Those who believe in the primacy of residence-based taxation for portfolio income should take seriously the idea of allowing only a deduction for foreign withholding taxes rather than a credit.[5]

The real problem with portfolio income, which is related to today's discussions about the real problems with transfer pricing, is the residence nations' inability to collect tax on foreign portfolio income. There is a lack of information flowing between countries. The critical question is whether multilateral cooperation, multilateral innovations, and expanded information reporting will get us to a point where we can collect tax on portfolio income earned abroad. Greater multilateral cooperation is essential.

This is related to the pervasive problem of enforcement inadequacy generally. The IRS is able to engage only in limited enforcement. IRS efforts, for example, to determine who has foreign bank accounts by looking at debit cards in foreign banks were well-publicized, but after the IRS found all these people—which was a shocking number—there was not much it could do about collecting the tax owed because of inadequate resources. It is impossible to enforce an income tax in the modern world if Congress doesn't give the IRS the resources to do its job.

Outdated Concepts

Let me make two other general comments. The first is about outdated concepts. We have an international income tax system built on concepts that are no longer relevant, if they ever were.

Corporate residence is perhaps the best example. The idea of income taxation of a multinational corporation turning on its residence seems bizarre in today's world. Corporate residence may have made sense in the early 20th century, when our international tax rules were put in place, but it makes no sense in the 21st century. We need to decrease or eliminate those income tax consequences that depend on where a corporation is resident.

Our source classifications—although we have not talked about this here today—also suffer major shortcomings in a world where financial derivatives are commonplace. The idea that we can readily distinguish interest, dividends and capital gains is tenuous. E-commerce also obviously imposes important challenges for source rules. The source rules need to be re-thought. That work has not yet really begun.

I also want to say a few words about transfer pricing, which everyone agrees is a crucial problem. The argument to date has been between arm's-length approaches on the one hand, and formulary approaches on the other. This argument is, I think, archaic for several reasons. The formulary methods of apportionment that the states rely on to apportion their taxes have nothing specifically in their formulas for intangibles. As we all know, intangibles have become crucially important to the production of income. Perhaps sales, to some extent, play a role in substituting for a specific value for intangibles. This may be why some analysts have called for allocating some income to the country of consumption.

As an alternative to the states' formulas, the profit-split methods of the Code Sec. 482 regulations have began to give us some new ideas that move toward new formulary-type apportionments. We should ask whether new profit-split methods might also help solve the critical source questions. There may be an opportunity for profit-split ideas to help in solving source questions as well as addressing transfer pricing issues. There seems to be some genuine promise here.

To return to David Rosembloom's earlier example, my fundamental question is whether the correct number for income in Bermuda is really $25. If it is really $25 of income earned in Bermuda and it is really active business income, then whether to impose an income tax is up to Bermuda. But I don't believe the number is $25. I believe it's closer to $5. That debate goes to the heart of David's question.[6]

The Role of International Organizations

One issue that has not been mentioned at all here today and that we generally are not sufficiently alert to in the United States is the increasing role of international organizations in the international tax arena. The World Trade Organization (WTO) has made its relevance apparent with its adverse ETI decision. But, with the exception of the WTO, we have not thought enough about how international organizations are operating and how they potentially will affect our international tax policies.

Take the EU, for example, and in particular the way the Europe Court of Justice (ECJ) has been affecting the income tax arena. Under current EU treaties and the new draft constitution of the EU, the ECJ has the power to strike down income tax laws. But there is no power within the EU to create income tax laws absent unanimous agreement of the member states. The retreat from imputation credit methods of corporate integration in the EU was, in my view, prompted in substantial part by decisions of the European Court of Justice. Recent ECJ decisions on earnings stripping threaten the ability of nations within the EU to collect corporate taxes whenever corporate structures are heavily debt-financed. The treatment of foreign losses by the ECJ is a further example. We need to pay attention to these developments because as European nations change their tax systems in response to ECJ decisions, they may well change policy calculations for us. The ECJ is becoming a new source of pressure on our own international income tax policies.

This development also may undermine to some significant degree the OECD's longstanding role as the arbiter of international tax rules. The OECD's efforts to address what it labeled harmful tax competition may be an instance of the OECD's waning authority, not only in setting substantive rules, but also in inducing multi-lateral enforcement cooperation, which also is currently being questioned. This threat to multi-lateral enforcement is no accident. The U.S. proponents of inhibiting the OECD's ability to promote information exchanges for foreign capital income include, for example, entities, such as the Heritage Foundation and the Cato Institute, who have been urging that we should not have an income tax in the United States and that capital income should not be taxed. The link between these two positions is apparent. If globalization means that governments cannot collect the income tax on capital income, it becomes difficult to keep the income tax in force. If we do not have

multilateral enforcement cooperation, we will see something of an international race to the bottom in terms of the taxation of income from capital. We do not need cooperation in setting tax rates, but we must have cooperation on information sharing and tax collection. There is considerable pressure internationally on tax rates and within the United States a real effort to move us away from taxing income toward taxing only consumption.

Conclusion

Let me close with this observation. I believe the United States has the wrong mix of taxes. I have written about this at some length. We rely much too heavily on the income tax and not nearly enough on consumption taxes in the United States. I do not believe we should rely entirely on a value-added tax or other consumption tax. Nor am I persuaded that we should eliminate the income tax altogether. Instead, I would enact a 10- to 14-percent value-added tax to finance a $100,000 exemption from the income tax as well as a reduction in the top income tax rate to 25 percent for both individuals and corporations. I have detailed this proposal in a YALE LAW JOURNAL article.[7] The numbers actually work. You don't need sunsets and phase-ins and all the other gimmicks now common in Congress in order to make this proposal work. It would have the great advantage of freeing about 150 million Americans from having to file tax returns. And it would be a much more coherent tax system. It would allow us to collect taxes on sales in the United States through the value added tax even when we are experiencing slippage in our ability to collect the income tax.

There are important reasons to take seriously a fundamental restructuring of the U.S. tax system domestically. We also need a fundamental re-thinking of the international tax regime. This conference has been an excellent opportunity for us to begin to debate these issues. Thank you.

ENDNOTES

This speech took place on November 14, 2003, and has been edited and annotated.

MICHAEL J. GRAETZ, FOUNDATIONS OF INTERNATIONAL INCOME TAXATION (2003); Michael J. Graetz and Itai Grinberg, *Taxing International Portfolio Income*, 56 TAX LAW REV. 537 (2003); Michael J. Graetz and Paul W. Oosterhuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations*, LIV NAT'L TAX J., 4, at 771 (Sept. 2001); Michael J. Graetz, *The David R. Tillinghast Lecture: Taxing International Income—Inadequate Principles, Outdated Concept, and Unsatisfactory Policy*, 54 TAX LAW REV. 261 (2001), *also published at* 26 BROOKLYN J. INT'L LAW 1357 (2001); Michael J. Graetz and Michael O'Hear, *The "Original Intent" of U.S. International Taxation*, 51 DUKE LAW J. 1021(1997).

[2] Mihir A. Desai, *New Foundations for Taxing Multinational Corporations*, TAXES, Mar. 2004.

[3] See Graetz and Oosterhuis, *supra* note 1.

[4] *Id.*

[5] *Id.*, at 568–75.

[6] H. David Rosenbloom, *Thinking About Subpart F: The Domestic Base Company*, TAXES, Mar. 2004.

[7] Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, 112 YALE LAW J. 261 (Nov. 2002).

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6172

OA Num.:
7601

NARA Num.:
7500

FOIA IDs and Segments:
2015-0056-F

RESTRICTION CODES

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FORM	SUBJECT/TITLE	PAGES	DATE	RESTRICTION(S)
Memorandum	Dividend Repatriation - To: Ben Bernanke - From: John Anderson	2	10/21/2005	P5;

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COLLECTION:
Council of Economic Advisers

SERIES:
Anderson, John - Subject Files

FOLDER TITLE:
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FORM	SUBJECT/TITLE	PAGES	DATE	RESTRICTION(S)
Email	RE: repatriated profits tax holiday - To: Ben Bernanke, et al - From: Gary D. Blank	2	10/17/2005	P5;

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FORM	SUBJECT/TITLE	PAGES	DATE	RESTRICTION(S)
Memorandum	Territorial vs Worldwide Taxation of Corporate Income - To: Harvey Rosen - From: Jerry Auten, et al	2	N.D.	P5;

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Taxing Foreign Income of U.S. Businesses

1. U.S. Taxation of multinational corporations
    a. U.S. firms that operate internationally are subject to corporate income tax in the U.S. on all of their net income, regardless of where it was earned, at the standard tax rate.
    b. A credit is provided for taxes paid to foreign governments, with the maximum amount of credit not exceeding the amount that would have been owed under the U.S. tax system.[1]
        i. Consider a simple example of a U.S. based multinational firm earning $100 million in net income on its operations in the U.S. and Country X. Suppose that Country X taxes the firm's net income in that country, requiring the firm to pay $15 million in tax. Under U.S. tax law, the firm owes $35 million (based on the 35% corporate income tax rate). The firm qualifies for a foreign tax credit of $15 million on its U.S. corporate income tax, leaving it with a net U.S. tax liability of $20 million.
        ii. In the year 2000, for example, there were 5,917 corporate income tax returns filed with claims for foreign tax credits. The total U.S. income tax owed by the firms filing these returns was $163 billion, which was reduced by $48 billion with foreign tax credits claimed.[2]
    c. Complications in the taxation of foreign-sourced corporate income
        i. Interactions between international tax systems lead to varying tax outcomes, depending upon how the business activity is configured.
            1. A U.S. corporation that directly conducts its business in another country must pay U.S. tax on its net income earned in that country.
            2. If the U.S. corporation separately incorporates its foreign business operation, the foreign subsidiary is not subject to U.S. tax on this foreign source income.
            3. In general, a U.S. parent corporation is not subject to U.S. tax on the net income of its foreign subsidiaries unless and until that income is repatriated via dividend distributions (subject to certain restrictions and anti-deferral regime applications).[3]
        ii. Foreign subsidiaries are foreign corporations owned by U.S. corporations. The income earned by a U.S. corporation via a foreign subsidiary is not taxable in the U.S. unless and until that income is returned to the U.S. corporation. Net income earned by the foreign subsidiary is taxable by the foreign government and not taxable in the U.S. unless it is repatriated to the U.S. parent corporation in the form of dividends. Repatriation of dividends to the U.S. parent company triggers U.S. corporate income tax. Hence, as long as the net income is retained in the foreign subsidiary those retained earnings are beyond the reach of the U.S. tax system. This

[1] Other countries taxing the worldwide income of corporations and applying a foreign tax credit include Greece, Italy, Japan, Norway, and the United Kingdom. Source: Desai, Foley, and Hines (2003, p.63).
[2] IRS Statistics of Income Division, Table 1: http://www.irs.gov/pub/irs-soi/00it01mi.xls
[3] Office of Tax Policy, U.S. Department of Treasury, 2000. *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations,* p.104.

feature of the tax system provides a potential deferral of U.S. taxation, which is valuable to the corporation.[4]

1. The value of this deferral depends on the two tax rates involved. If the tax rate applied in Country X is higher than that applied in the U.S., say 40% for example, then there is no additional tax due to the U.S. (the foreign tax credit provides up to the U.S. amount of tax, but not more) and there is, therefore, no benefit to deferral.
2. If, on the other hand, the corporate income tax rate in Country X is below that in the U.S., then there is a benefit to the corporation from deferral. If Country X applies a 20% corporate income tax rate, for example, then there is a potential deferral associated with the 15% of the subsidiary's net income that is not taxed in the U.S. The longer the U.S. parent corporation waits to repatriate those profits, the less the amount of the tax in present value terms. Tax deferred is tax saved.
    a. Consider an example of a U.S. corporation with a foreign subsidiary that earns $500 million in net income in a country with a corporate income tax rate of 20%. The subsidiary must pay $100 million in tax to the foreign government. Of its $400 million after-tax income, it might remit $100 million in dividends to its U.S. parent corporation and retain $300 million. The U.S. parent corporation must pay tax on the $100 million in dividends received, less its foreign tax credit. The foreign tax credit is $25 million, or the product of foreign taxes paid by its subsidiary ($100 million) times the ratio of the subsidiary company's dividends to after-tax profits: ($100/$400). This computation reflects the fact that dividends are treated as U.S. source in proportion to the U.S. source earnings and profits of the U.S. owned foreign corporation[5] The U.S. corporation pays no U.S. tax on any of the $300 million earned by the subsidiary and unremitted to the parent company.
    b. If the subsidiary pays a dividend to the U.S. parent company the following year, the company must pay U.S. tax, net of foreign tax credit.
    c. U.S. tax law includes provisions in Subpart F that are designed to prevent firms from delaying repatriation of foreign earnings that are lightly taxed. Such provisions apply to controlled foreign corporations (CFCs), which are foreign corporations with at least 50% U.S. ownership. [6]

[4] Deferral is a common feature of tax systems that tax foreign income. This method is also used by Canada, Denmark, France, Germany, Japan, Norway, Pakistan, and the United Kingdom. Source: Desai, Foley, and Hines (2003, p. 64).

[5] CCH Incorporated, 2003. *2004 U.S. Master Tax Guide*, Chicago: CCH Incorporated. See paragraph 2477, p.670.

[6] For more information on CFCs see OTP, U.S. Department of Treasury (2000).

Under Subpart F provisions, some foreign income can be deemed distributed and therefore be taxable—a form of presumptive taxation.

d. The limitation that the foreign tax credit be no more than the amount of tax that would have been paid under the U.S. tax system leads to both "excess" and "deficit" foreign tax credits, depending upon whether the firm's foreign tax paid exceeds or falls short of the amount allowed for the foreign tax credit.
e. Subpart F provisions have been criticized by some international tax analysts as being out of step with our major trading partners, placing U.S. multinational firms at a competitive disadvantage.[7]
f. Subpart F is one of a set of measures designed to reduce tax avoidance problems. Fundamentally, the tax avoidance problems are caused by an inherent tension in the tax system. That internal tension is due to (1) the incompatibility of taxing worldwide income and (2) the treatment of corporations as taxpayers and legal persons distinct from their owners.[8]
g. The U.S. Treasury Department has outlined three potential policy options designed to end deferral:[9]
    i. Repeal of deferral
    ii. Tax all foreign income currently at a lower tax rate
    iii. Retain current Subpart F rules, with the exception of foreign-to-foreign related party rules

3. As a consequence offshore tax havens are common, where small countries with low tax rates provide a tax haven for U.S. corporations. [cite EU list of tax havens here]

d. Estimates of the economic effects of delayed dividend repatriation
    i. Desai, Foley, and Hines (2001) have analyzed the economic effects of the U.S. system and found the following:
        1. Dividend remittances from incorporated foreign affiliates are sensitive to taxes. A10% higher repatriation tax is associated with 10% lower dividends.
        2. U.S. adoption of a territorial tax system would increase aggregate dividend payouts by 12.8%, with widely varying effects between affiliates in different tax situations.
        3. Repatriation taxes reduce economic efficiency, with strong incentives to remit dividends from some foreign affiliates (in

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[7] Statement of Phillip D. Morrison, Testimony before the House Committee on Ways and Means, Hearing on the Impact of U.S. Trade Rules on International Competitiveness, June 30, 1999. http://waysandmeans.house.gov/legacy/fullcomm/106cong/6-30-99/6-30morr.htm.

[8] Office of Tax Policy, U.S. Department of Treasury, 2000. *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations,* p.104.

[9] Office of Tax Policy, U.S. Department of Treasury, 2000. *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations,* pp.86-99.

higher tax countries) rather than others (in lower tax countries). The loss of economic efficiency has the distributional and incentive effects of an extra tax imposed on U.S. Multinationals. Estimates indicate that the annual efficiency loss due to dividend repatriation taxes is 2.5% of dividends.

ii. Altshuler and Grubert ()

e. Eugene Steuerle (1992) has summarized the system that arose from TRA86 as follows: "The taxation of international income was made extraordinarily complex and represented one of the major sources of complaint by tax practitioners. Some complexity was caused by the drive to achieve a revenue target, rather than a target based upon some set of principles. On the other hand, some complexity was inevitable, as the attribution of cost and income among various affiliates and subsidiaries operating in multiple jurisdictions at different exchange rates is necessarily complicated. Another source of difficulty was the simple lack of a consensus on how to tax and measure income of multinational companies and their owners. The common practice—where corporate income was taxed on the basis of the source while interest, dividends and other payments were taxed on the basis of residence of the recipient—has a long history that is embodied in both law and tax treaties, although it results in inconsistent treatment of income from equity versus income from debt."[10]

2. Foreign dividend repatriation holiday available in 2005

a. As part of the American Jobs Creation Act Congress granted a one-time opportunity to repatriate dividends in order to stimulate the U.S. economy.

i. IRC section 965 grants an 85% deduction for dividends received to the U.S. shareholders of a U.S. controlled foreign corporation (CFC).

ii. The deduction is available for extraordinary cash dividends from a CFC.

iii. The amount of the deduction is capped at the greater of (1) $500 million, or (2) APB 23 amount disclosed in SEC filing. The amount of DFD cash dividends cannot exceed the excess of cash and non-cash dividends received by the taxpayer during the year from CFCs over a base period amount.

iv. The dividends must be invested according to an approved reinvestment plan.

v. The reinvestment plan must fund hiring of workers, training, infrastructure, research and development, capital improvements, or financial stabilization of the corporation with the objective of retaining or creating jobs.

vi. Foreign tax credit is disallowed on the deductible portion of the CFC cash dividends.

[10] Steuerle, C. Eugene, 1992. *The Tax Decade: How Taxes Came to Dominate the Public Agenda*, The Urban Institute Press, Washington, DC, pp. 157-58.

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JOINT COMMITTEE ON TAXATION
October 7, 2004
JCX-69-04

ESTIMATED BUDGET EFFECTS OF THE CONFERENCE AGREEMENT FOR H.R. 4520, THE "AMERICAN JOBS CREATION ACT OF 2004"

Fiscal Years 2005 - 2014

[Millions of Dollars]

Provision	Effective	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2005-09	2005-14
I. Provisions Relating to Repeal of Exclusion for Extraterritorial Income													
1. Repeal of exclusion for extraterritorial income [1]	ta 12/31/04	354	1,317	3,528	5,475	5,737	5,985	6,275	6,562	6,840	7,126	16,411	49,199
2. Deduction relating to income attributable to United States production activities	tyba 12/31/04	-2,054	-3,052	-4,396	-6,241	-6,722	-8,841	-10,741	-11,122	-11,525	-11,815	-22,465	-76,509
Total of Provisions Relating to Repeal of Exclusion for Extraterritorial Income		**-1,700**	**-1,735**	**-868**	**-766**	**-985**	**-2,856**	**-4,466**	**-4,560**	**-4,685**	**-4,689**	**-6,054**	**-27,310**
II. Business Tax Incentives													
A. Small Business Expensing - increase section 179 expensing from $25,000 to $100,000 and increase the phaseout threshold amount from $200,000 to $400,000; include software in section 179 property; and extend indexing of both the deduction limit and the phaseout threshold (sunset after 2007)	tyba 12/31/05	---	-3,814	-6,636	-488	3,786	2,416	1,665	1,116	609	249	-7,152	-1,095
B. Depreciation													
1. 15-year straight-line cost recovery for qualified leasehold improvements (sunset after 2005)	ppisa DOE	-65	-147	-185	-181	-174	-158	-151	-159	-156	-149	-751	-1,523
2. 15-year straight-line cost recovery for qualified restaurant improvements (sunset after 2005)	ppisa DOE	-141	-33	-40	-40	-40	-40	-40	-40	-40	-40	-294	-494
C. Community Revitalization													
1. Modification of targeted areas and low-income communities designated for new markets tax credit	DMA DOE	*No Revenue Effect*											
2. Expansion of designated renewal community area based on 2000 census data	[2]	-35	-10	-10	-9	-9	[3]	8	9	9	8	-71	-37
3. Modification of income requirement for census tracts within high migration rural counties	[4]	*No Revenue Effect*											
D. S Corporation Reform and Simplification													
1. Treat members of family as one shareholder (6 generations; multiple families per S corporation) (includes interaction with line 2. below)	generally tyba 12/31/04	-1	-4	-6	-8	-9	-9	-10	-10	-10	-10	-27	-76
2. Increase in number of eligible shareholders to 100	tyba 12/31/04	-18	-43	-56	-66	-74	-79	-82	-83	-84	-84	-257	-669
3. Expansion of bank S corporation eligible shareholders to include IRAs	DOE	-23	-34	-36	-37	-39	-41	-43	-45	-47	-49	-170	-394
4. Disregard unexercised powers of appointment in determining potential current beneficiaries of ESBT	tyba 12/31/04	*Negligible Revenue Effect*											
5. Transfer of suspended losses incident to divorce	tyba 12/31/04	-1	-2	-2	-2	-3	-3	-3	-3	-3	-3	-11	-25

Provision	Effective	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2005-09	2005-14
6. Use of passive activity loss by subchapter S trust income beneficiaries	tma 12/31/04	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-4	-7
7. Exclusion of investment securities income from passive income test for bank S corporations	tyba 12/31/04	*Negligible Revenue Effect*											
8. Relief from inadvertently invalid qualified subchapter S subsidiary elections and terminations	ematma 12/31/2004	-2	-1	-1	-1	-1	-1	-1	-1	-1	-1	-7	-14
9. Information returns for qualified subchapter S subsidiaries	tyba 12/31/04	*No Revenue Effect*											
10. Repayment of loan for qualifying employer securities held by an ESOP	dma 12/31/97	-1	[5]	[5]	[5]	[5]	[5]	[5]	-1	-1	-1	-3	-5
E. Other Business Incentives													
1. Repeal of 4.3-cent General Fund excise taxes on railroad diesel fuel and inland waterway fuel (reduce excise taxes by 1 cent/gallon from 1/1/05 through 6/30/05, 2 cents/gallon from 7/1/05 through 12/31/06, and 4.3 cents/gallon thereafter)	1/1/05	-33	-74	-139	-170	-174	-179	-184	-189	-193	-198	-591	-1,532
2. Modification of application of the income forecast method of accounting	ppisa DOE	-182	-139	-81	-32	-24	-24	-28	-31	-35	-39	-458	-615
3. Improvements related to real estate investment trusts	tyba 12/31/00 & tyba DOE	*Negligible Revenue Effect*											
4. Special rules for certain film and television production (sunset taxable years beginning after 12/31/08)	pca DOE	-82	-99	-94	-60	-1	62	93	81	40	18	-336	-42
5. Provide a 50% tax credit for certain expenditures for maintaining railroad tracks	epoid tyba 12/31/04 & tybb 1/1/08	-63	-121	-109	-88	-59	-38	-21	-4	[5]	[5]	-439	-501
6. Suspension of the occupational taxes relating to distilled spirits, wine, and beer (sunset 6/30/08)	7/1/05	-66	-78	-78	-12	---	---	---	---	---	---	-234	-234
7. Modification of unrelated business income limitation on investment in certain debt-financed properties of SBICs	[6]	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-3	-9
8. Tonnage tax election for income from international shipping	tyba DOE	-2	-4	-5	-6	-6	-6	-6	-7	-7	-8	-23	-57
F. Exclusion of Incentive Stock Options and Employee Stock Purchase Plan Stock Options From Wages	saptoea DOE	*No Revenue Effect*											
Total of Business Tax Incentives		**-717**	**-4,605**	**-7,480**	**-1,203**	**3,171**	**1,898**	**1,196**	**631**	**79**	**-309**	**-10,830**	**-7,329**
III. Provisions Relating to Tax Relief for Agriculture and Small Manufacturers													
A. Volumetric Ethanol Excise Tax Credit													
1. Provide excise tax credit (in lieu of reduced tax rate on gasoline) to certain blenders of alcohol fuel mixtures (sunset 12/31/10)	fsoua 12/31/04	*No Revenue Effect*											
2. Provide that all alcohol fuels excise tax credits and payments are paid from the General Fund [7]:													
a. Revenue effects	fsoua 12/31/04	---	---	---	---	---	---	1,131	1,559	1,586	1,614	---	5,890
b. Outlay effects [8] [9]	fsoua 12/31/04	---	---	---	---	---	---	-19	-32	-54	-66	---	-171

Provision	Effective	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2005-09	2005-14
3. Repeal reduced-rate sales of gasoline for blending with alcohol and reduced-rate sales of alcohol fuel blends	fsoua 12/31/04	16	23	23	23	23	23	23	22	22	22	109	220
4. Provide outlay payments (in lieu of excise tax credits and refunds) to producers of alcohol fuel mixtures:													
a. Revenue effects	fsoua 12/31/04	77	114	116	117	119	121	38	---	---	---	543	702
b. Outlay effects [8] [10]	fsoua 12/31/04	-77	-114	-116	-117	-119	-121	-38	---	---	---	-543	-702
5. Transfer full amount of alcohol fuel excise taxes to the Highway Trust Fund (i.e., repeal 2.5/2.8 cents transfer to General Fund)	fsoua 9/30/04	*No Revenue Effect*											
6. Provide excise tax credits for biodiesel used to produce a qualified fuel mixture [11] ($1.00/gallon for agribiodiesel and $0.50/gallon for biodiesel) and provide that the excise tax credits are paid from the General Fund (sunset 12/31/06):													
a. Revenue effects	fsoua 12/31/04	-33	-57	-16	---	---	---	---	---	---	---	-107	-107
b. Outlay effects [8] [9]	fsoua 12/31/04	30	32	2	---	---	---	---	---	---	---	64	64
7. Provide outlay payments (in lieu of excise tax credits and refunds) to producers of biodiesel fuel mixtures:													
a. Revenue effects	fsoua 12/31/04	*Negligible Revenue Effect*											
b. Outlay effects [8] [10]	fsoua 12/31/04	*Negligible Outlay Effect*											
8. Extension of section 40 alcohol fuels income tax credit (sunset 12/31/10)	DOE	---	---	---	-2	-6	-8	-8	-6	-3	---	-8	-34
9. Biodiesel income tax credit - provide income tax credits for biodiesel fuel and biodiesel used to produce a qualified fuel mixture ($1.00/gallon for agribiodiesel and $0.50/gallon for biodiesel) (sunset 12/31/06)	fpasoua 12/31/04	*Estimate Included in Item 6. Above*											
10. Information reporting for persons claiming ethanol and biodiesel tax benefits	1/1/05	*Negligible Revenue Effect*											
B. Agricultural Incentives													
1. Special rules for livestock sold on account of weather-related conditions	trda 12/31/02	-18	-7	-4	-3	-3	-3	4	6	2	[3]	-35	-27
2. Payment of dividends on stock of cooperatives without reducing patronage dividends	di tyba DOE	[5]	[5]	-1	-1	-1	-1	-2	-2	-3	-4	-3	-15
3. Allow small ethanol producer cooperatives to pass the small producer credit through to cooperative members	tyea DOE	-8	-8	-9	-10	-11	-12	-10	-6	-3	---	-47	-77
4. Extend income averaging to fishermen and provide that income averaging for farmers and fishermen will not increase AMT liability	tyba 12/31/03	-3	-3	-4	-5	-6	-7	-7	-8	-9	-10	-20	-61
5. Capital gains treatment to apply to outright sales of timber by landowner	sota 12/31/04	*Negligible Revenue Effect*											
6. Modify cooperative marketing to include value-added processing involving animals	tyba DOE	-1	-2	-4	-5	-6	-7	-9	-10	-11	-12	-19	-68
7. Extend declaratory judgment relief to farm cooperatives	pfa DOE	*Estimate Included in Line Above*											

Provision	Effective	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2005-09	2005-14
8. Certain expenses of rural letter carriers	tyba 12/31/03	-2	-3	-3	-3	-3	-3	-4	-4	-4	-4	-15	-33
9. Treatment of certain income of electric cooperatives (sunset 12/31/06)	tyba DOE	-10	-19	-8	---	---	---	---	---	---	---	-38	-38
10. Exclude from gross income and employment taxes payments made to individuals under NHSC Loan Repayment Program and certain State loan repayment programs	tyba 12/31/03	-2	-2	-2	-4	-5	-6	-8	-11	-14	-18	-15	-72
11. Modified safe-harbor rules for timber REITs	tyba DOE	[5]	[5]	-1	-1	-2	-2	-3	-4	-5	-5	-4	-23
12. Deduction of the first $10,000 of qualified reforestation costs	epoia DOE	-55	-37	-25	-11	-1	2	8	13	20	22	-129	-64
C. Incentive for Small Manufacturers													
1. Net income from publicly traded partnerships treated as qualifying income for regulated investment company	tyba DOE	-1	-2	-3	-5	-5	-6	-6	-7	-7	-7	-16	-49
2. Simplification of excise tax imposed on bows and arrows:													
a. Revenue effects	asbmpoi 30da DOE	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-4	-9
b. Outlay effects [8]	asbmpoi 30da DOE	1	1	1	1	1	1	1	1	1	1	3	8
3. Reduce excise tax on fishing tackle boxes to 3 percent:													
a. Revenue effects	asbmpoia 12/31/04	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-5	-11
b. Outlay effects [8]	asbmpoia 12/31/04	[12]	1	1	1	1	1	1	1	1	1	4	10
4. Repeal excise tax on sonar devices suitable for finding fish:													
a. Revenue effects	asbmpoia 12/31/04	[5]	[5]	[5]	[5]	[5]	[5]	-1	-1	-1	-1	-2	-4
b. Outlay effects [8]	asbmpoia 12/31/04	[12]	[12]	[12]	[12]	[12]	[12]	[12]	[12]	[12]	1	1	3
5. Charitable contribution deduction for certain expenses in support of Native Alaska subsistence whaling	cma 12/31/04	[5]	[5]	[5]	[5]	[5]	[5]	[5]	[5]	[5]	[5]	-1	-4
6. Extended placed in service date for bonus depreciation for certain aircraft (excluding aircraft used in the transportation industry)	ppisa 9/10/01 [13]	-1,265	-175	576	346	271	194	54	---	---	---	-247	---
7. Special placed in service rule for bonus depreciation for certain property subject to syndication	sa 6/4/04	-27	8	6	4	4	4	2	1	---	---	-5	---
8. Expensing of capital costs incurred for production in complying with Environmental Protection Agency sulfur regulations for small refiners	epoia 12/31/02	-16	-8	-12	-28	-53	-21	3	4	5	6	-117	-119
9. Credit for small refiners for production for diesel fuel in compliance with Environmental Protection Agency sulfur regulations for small refiners	epoia 12/31/02	*Estimate Included in Line Above*											
10. Modification to small issue bonds - increase capital expenditure limit from $10 million to $20 million (maximum bond limit remains at $10 million)	bia 9/30/09	---	---	---	---	---	-6	-14	-22	-30	-38	---	-110
11. Oil and gas from marginal wells	pi tyba 12/31/04	*No Revenue Effect*											
Total of Provisions Relating to Tax Relief for Agriculture and Small Manufacturers		**-1,396**	**-260**	**515**	**295**	**196**	**141**	**1,134**	**1,492**	**1,491**	**1,500**	**-656**	**5,099**

Provision	Effective	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2005-09	2005-14
IV. Tax Reform and Simplification for United States Businesses													
1. Interest expense allocation rules	tyba 12/31/08	---	---	---	---	-908	-2,487	-2,586	-2,689	-2,797	-2,909	-908	-14,376
2. Recharacterize overall domestic loss	If tyba 12/31/06	---	---	-57	-680	-713	-756	-793	-829	-862	-895	-1,450	-5,585
3. Apply look-through rules for dividends from noncontrolled section 902 corporations	tyba 12/31/02	-662	-51	-23	-6	-1	[14]	[14]	[14]	[14]	[14]	-743	-743
4. Base differences and reduction to 2 foreign tax credit baskets	[15]	-8	-13	-615	-900	-927	-1,002	-1,039	-1,078	-1,119	-1,161	-2,463	-7,862
5. Attribution of stock ownership through partnerships in determining section 902 and 960 credits	tyba DOE	-1	-3	-3	-3	-3	-3	-3	-3	-3	-3	-13	-28
6. Foreign tax credit treatment of deemed payments under section 367(d)	ataro/a 8/5/97	-26	-5	-5	-5	-5	-5	-5	-5	-5	-5	-46	-71
7. United States property not to include certain assets of controlled foreign corporations	[16]	-3	-20	-21	-22	-23	-24	-25	-27	-29	-31	-89	-225
8. Translation of foreign taxes	tyba 12/31/04	*Negligible Revenue Effect*											
9. Eliminate secondary withholding tax with respect to dividends paid by certain foreign corporations	pma 12/31/04	-2	-3	-3	-3	-3	-3	-3	-3	-3	-3	-14	-29
10. Provide equal treatment for interest paid by foreign partnerships and foreign corporations doing business in the U.S.	tyba 12/31/03	-3	-2	-2	-2	-2	-2	-2	-3	-3	-3	-11	-24
11. Treatment of certain dividends of regulated investment companies (sunset after 3 years)	[17]	-7	-59	-63	-57	---	---	---	---	---	---	-186	-186
12. Look-through treatment under subpart F for sales of partnership interests	[16]	-39	-91	-96	-101	-106	-111	-116	-122	-129	-137	-433	-1,048
13. Repeal of rules applicable to foreign personal holding companies and foreign investment companies, personal holding company rules as they apply to foreign corporations, and include in subpart F personal service contract income, as defined under the foreign personal holding company rules	[16]	-25	-65	-73	-81	-91	-102	-114	-128	-143	-162	-335	-984
14. Determination of foreign personal holding company income with respect to transactions in commodities	teia 12/31/04	-4	-10	-10	-10	-10	-11	-11	-11	-11	-12	-44	-100
15. Modify treatment of aircraft leasing and shipping income [18]	[16]	-33	-172	-98	-75	-76	-88	-98	-108	-118	-129	-454	-995
16. Modification of exceptions under subpart F for active financing income	[16]	*Negligible Revenue Effect*											
17. 10-year foreign tax credit carryforward; 1-year foreign tax credit carryback	[19]	-349	-271	-338	-500	-668	-779	-857	-942	-1,036	-1,191	-2,126	-6,931
18. Modify FIRPTA rules for REITs	tyba DOE	-2	-7	-10	-12	-14	-15	-17	-19	-21	-23	-45	-140
19. Exclusion of certain horse-racing and dog-racing gambling winnings from the income of nonresident alien individuals	wma DOE	-1	-3	-3	-3	-3	-3	-3	-3	-3	-3	-12	-27
20. Reduce withholding tax applicable to dividends paid to Puerto Rico companies to 10%	Dpa DOE	-5	-7	-8	-9	-10	-10	-11	-12	-13	-14	-39	-99
21. Repeal the 90% limitation on the use of foreign tax credits against the AMT	tyba 12/31/04	-265	-395	-376	-361	-348	-338	-329	-323	-319	-317	-1,745	-3,371
22. Incentives to reinvest foreign earnings in the United States	[20]	2,788	-2,119	-1,267	-838	-553	-379	-300	-264	-192	-137	-1,989	-3,261

Provision	Effective	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2005-09	2005-14
23. Delay in effective date of final regulations governing exclusion of income from international operation of ships or aircraft	[21]	-24	-4	[5]	[5]	[5]	[5]	[5]	[5]	[5]	[5]	-28	-28
24. Study of earnings stripping provisions		*No Revenue Effect*											
25. Interaction	---	3	192	248	253	410	429	450	473	497	523	1,106	3,478
Total of Tax Reform and Simplification for United States Businesses		**1,332**	**-3,108**	**-2,823**	**-3,415**	**-4,054**	**-5,689**	**-5,862**	**-6,096**	**-6,309**	**-6,612**	**-12,067**	**-42,635**
V. Deduction of State and Local General Sales Taxes (sunset 12/31/05)	**tyba 12/31/03**	**-3,080**	**-1,915**	**---**	**---**	**---**	**---**	**---**	**---**	**---**	**---**	**-4,995**	**-4,995**
VI. Fair and Equitable Tobacco Reform Provisions [22]													
A. Revenue effects	DOE	1,098	1,089	964	964	964	964	964	964	964	1,205	5,079	10,140
B. Outlay effects [8]	DOE	-1,464	-964	-964	-964	-964	-964	-964	-964	-964	-964	-5,320	-10,140
Total of Fair and Equitable Tobacco Reform Provisions		**-366**	**125**	**---**	**---**	**---**	**---**	**---**	**---**	**---**	**241**	**-241**	**---**
VII. Miscellaneous Provisions													
1. Qualified green building and sustainable design project bonds ($2 billion authority)	bia 12/31/04 & bib 10/1/09	-3	-9	-15	-22	-27	-31	-31	-31	-31	-31	-76	-231
2. Exclusion of gain or loss on sale or exchange of certain Brownfield sites from unrelated business taxable income	PAa 12/31/04 & PAb 1/1/10	1	1	1	-6	-18	-28	-38	-49	-34	-15	-21	-185
3. Civil rights tax relief	josoa DOE	-5	-21	-29	-31	-34	-36	-38	-42	-44	-47	-120	-327
4. 7-year recovery period for certain track facilities	ppisa DOE & before 2008	-13	-19	-26	-23	-14	-9	-6	-3	3	9	-95	-101
5. Permit life insurance companies tax-free distributions from policyholder surplus accounts	tyba 12/31/04 & tybb 1/1/07	-78	-54	-51	-48	-48	-48	-49	-51	-52	-54	-279	-533
6. Treat certain Alaska pipeline property as 7-year property	generally ppisa 12/31/13	---	---	---	---	---	---	---	---	---	-150	---	-150
7. Extension of enhanced oil recovery credit to Alaska gas processing facilities	cpoii tyba 12/31/04	---	---	---	-32	-91	-101	-61	-23	1	11	-123	-295
8. Method of accounting for naval shipbuilders	ceia DOE	-26	-52	-99	-62	-42	-57	-35	-32	-38	-52	-281	-495
9. Modify minimum cost requirement for transfer of excess defined benefit assets	tyea DOE	*Negligible Revenue Effect*											
10. Extension and expansion of credit for electricity produced from certain renewable resources - expand section 45 credit to include closed-loop biomass, open-loop biomass, geothermal solar, small irrigation, municipal solid waste, and refined coal to list of qualified energy resources	ppisa DOE	-218	-279	-322	-366	-375	-261	-177	-135	-94	-49	-1,560	-2,278
11. Allow the section 40 and section 45 credits to be taken against the AMT	tyea DOE	-10	-5	-4	-3	-2	-2	2	6	1	-3	-25	-21
12. Inclusion of primary and secondary medical strategies for children and adults with sickle cell disease as medical assistance under the Medicaid program:													
a. Revenue effects	DOE	*No Revenue Effect*											
b. Outlay effects [8] [23]	DOE	-2	-6	-8	-10	-11	-14	-16	-18	-20	-21	-37	-126

Provision	Effective	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2005-09	2005-14
13. Temporary suspension of customs duty on certain ceiling fans (sunset 12/31/06) [24]	15da DOE	-19	-20	-5	---	---	---	---	---	---	---	-44	-44
14. Temporary suspension of customs duty on certain steam generators (sunset 12/31/08) and certain reactor vessel heads and pressurizers used in nuclear facilities (sunset 12/31/08) [24]	15da DOE & DOE	-1	-1	-3	-3	-1	---	---	---	---	---	-9	-9
Total of Miscellaneous Provisions		**-374**	**-465**	**-561**	**-606**	**-663**	**-587**	**-449**	**-378**	**-308**	**-402**	**-2,670**	**-4,795**
VIII. Revenue Provisions													
A. Provisions to Reduce Tax Avoidance Through Individual and Corporate Expatriation													
1. Tax treatment of expatriated entities	tyea 3/4/03	96	50	59	63	67	77	90	100	109	119	335	830
2. Excise tax on stock compensation of insiders in expatriated corporations (rate tracks capital gains rate, applies to executives in affiliated groups)	generally 3/4/03	18	7	7	7	8	11	11	11	11	11	47	102
3. Reinsurance of United States risks in foreign jurisdictions	rra DOE	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	2	5
4. Revision of tax rules for individuals who expatriate	iwea 6/3/04	23	21	24	28	32	37	43	49	56	64	128	377
5. Reporting of taxable mergers and acquisitions	aa DOE	2	3	3	3	3	3	3	3	3	3	14	29
6. Studies	DOE	*No Revenue Effect*											
B. Provisions Relating to Tax Shelters													
1. Provisions relating to reportable transactions and tax shelters	[25]	50	119	120	124	131	139	150	164	179	195	544	1,371
2. Modifications to the substantial understatement penalty for nonreportable transactions	tyba DOE	---	7	15	23	26	30	34	38	38	38	71	249
3. Modification of actions to enjoin certain conduct related to tax shelters and reportable transactions	da DOE	*Negligible Revenue Effect*											
4. Impose a civil penalty (of up to $10,000) on failure to report interest in foreign financial accounts	voa DOE	---	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	1	3
5. Regulation of individuals practicing before the Department of Treasury	ata DOE	*No Revenue Effect*											
6. Treatment of stripped interest in bond and preferred stock funds	pada DOE	13	11	8	5	3	[3]	[3]	[3]	[3]	[3]	40	40
7. Minimum holding period for foreign tax credit on withholding tax on income other than dividends	apoamt 30da DOE	3	3	3	3	4	4	4	4	5	5	16	38
8. Disallowance of certain partnership loss transfers with partner level loss limits for transfer of interest in electing investment partnerships	ctada DOE	28	56	62	60	54	47	43	43	44	44	260	481
9. No reduction of basis under section 734 in stock held by partnership in corporate partner	Da DOE	6	12	19	23	27	28	30	33	34	36	87	249
10. Repeal of special rules for FASITs	after 12/31/04	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	2	5
11. Limitation on transfer or importation of built-in losses	ta DOE	51	99	147	164	180	198	218	240	264	290	641	1,851
12. Clarification of banking business for purposes of determining investment of earnings in United States property	DOE	40	34	34	36	38	40	42	44	46	50	182	404
13. Deny deduction for interest paid to the IRS on underpayments involving certain tax motivated transactions	tyba DOE	---	1	1	3	4	4	4	4	4	4	9	29

Provision	Effective	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2005-09	2005-14
14. Clarification of rules for payment of estimated tax for certain deemed asset sales	toa DOE	55	28	7	3	3	3	4	4	5	5	96	117
15. Exclusion of like-kind exchange property from nonrecognition treatment on the sale or exchange of a principal residence	soea DOE	11	13	15	17	19	21	23	25	27	29	75	200
16. Prevent mismatching of deductions and income inclusions in transactions with related foreign persons	pao/a DOE	40	82	80	33	35	37	39	41	43	45	270	475
17. Deposits made to suspend the running of interest on potential underpayments	Dma DOE	150	-6	-6	-6	-6	-6	-7	-7	-7	-7	127	93
18. Authorize IRS to enter into installment agreements that provide for partial payment	iaeio/a DOE	52	10	5	[12]	[12]	[12]	[12]	[12]	[12]	[12]	67	67
19. Affirmation of consolidated return regulation authority	[26]	*Negligible Revenue Effect*											
20. Expanded disallowance of deduction for interest on convertible debt	diia 10/4/04	94	90	94	96	98	101	103	106	109	113	472	1,004
21. Reform the tax treatment for leasing transactions with tax-indifferent parties with additional coverage of Indian and intangible assets and assets subject to a fixed purchase price option with an exception for aircraft and vessels	[27]	589	934	1,416	1,955	2,474	2,923	3,352	3,805	4,293	4,819	7,368	26,560
C. Reduction of Fuel Tax Evasion													
1. Exemption from certain excise taxes for mobile machinery vehicles	[28]	76	95	95	95	95	95	95	95	95	95	456	931
2. Modified definition of off-highway vehicle	[28]	*Negligible Revenue Effect*											
3. Aviation jet fuel - move point of taxation of aviation fuel to the rack; provide that certain refueler trucks are treated as terminals	[29]	297	429	433	436	439	439	437	435	434	432	2,034	4,211
4. Dye fuel mechanically, security standards, and related penalties	[30]	---	42	46	47	47	47	47	47	47	47	181	417
5. Elimination of administrative review for taxable use of dyed fuel	Paa DOE	*Negligible Revenue Effect*											
6. Extension of penalty on untaxed chemically altered fuel mixtures	DOE	*Negligible Revenue Effect*											
7. Termination of dyed diesel use by intercity buses	fsa 12/31/04	*Negligible Revenue Effect*											
8. Authority to inspect on-site records	DOE	*Negligible Revenue Effect*											
9. Assessable penalty for refusal of entry	1/1/05	*Negligible Revenue Effect*											
10. Registration of all pipeline or vessel operators required for exemption of bulk transfers; Secretary must publish list of registered persons [31]	3/1/05	56	125	127	128	129	129	130	129	129	129	564	1,211
11. Display of registration and penalty for failure to display	1/1/05 & pia 12/31/04	*Revenue Effects Included in Line 10.*											
12. Penalties for failure to register and failure to report	pia 12/31/04	1	2	2	2	2	2	2	2	2	2	10	20
13. Registration of persons within foreign trade zones	1/1/05	*Revenue Effects Included in Line 10.*											
14. Certain reports filed electronically	1/1/06	*Revenue Effects Included in Line 10.*											
15. Taxable fuel refunds for certain ultimate vendors	1/1/05	*Negligible Revenue Effect*											
16. Two-party exchanges	DOE	*Negligible Revenue Effect*											
17. Modifications to heavy vehicle use tax	tpba DOE	121	124	126	128	131	131	133	135	137	139	630	1,305

Provision	Effective	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2005-09	2005-14
18. Dedication of revenue from certain penalties to the Highway Trust Fund	Pao/a DOE	*No Revenue Effect*											
19. Simplify the heavy truck tire tax [32]	[33]	*Negligible Revenue Effect*											
20. Taxation of transmix and diesel fuel blendstocks	frsoua 12/31/04	74	107	108	108	108	108	108	108	107	106	505	1,043
21. Treasury study on fuel compliance	DOE	*No Revenue Effect*											
D. Other Revenue Provisions													
1. Permit private sector debt collection companies to collect tax debts:													
a. Revenue effects	DOE	---	78	200	182	161	147	147	147	147	147	621	1,356
b. Outlay effects [8]	DOE	---	-19	-50	-45	-40	-37	-37	-37	-37	-37	-154	-339
2. Modify charitable contribution rules for donations of patents and other intellectual property; provide for additional charitable deductions in future years based on income attributable to the contributed property	cma 6/3/04	307	318	330	342	356	369	384	399	414	434	1,653	3,653
3. Require increased reporting for noncash charitable contributions	cma 6/3/04	9	9	10	10	10	10	10	11	11	11	49	102
4. Provide that deduction for charitable contribution of vehicles generally equals the sales price	cma 12/31/04	30	251	253	256	258	261	263	266	269	272	1,048	2,379
5. Treatment of nonqualified deferred compensation plans	ada 12/31/04	158	135	44	21	20	18	144	189	172	151	377	1,051
6. Extension of amortization of intangibles to acquisitions of sports franchises	aoa DOE	52	88	71	37	22	21	19	22	24	26	270	382
7. Increase continuous levy for certain Federal payments	DOE	8	14	16	19	19	20	21	22	23	24	76	185
8. Modification of straddle rules	peo/a DOE	21	24	27	31	34	36	38	39	40	41	137	331
9. Addition of vaccines against Hepatitis A to the list of taxable vaccines:													
a. Revenue effects	[34]	7	9	9	9	9	9	9	9	9	9	43	88
b. Outlay effects [8]	[34]	-6	-7	-7	-7	-7	-7	-7	-7	-8	-8	-34	-72
10. Addition of vaccines against Influenza to the list of taxable vaccines:													
a. Revenue effects	[35]	55	62	65	67	68	69	69	70	71	72	317	669
b. Outlay effects [8]	[35]	-29	-33	-34	-35	-36	-37	-37	-37	-38	-39	-167	-355
11. Extension of IRS user fees through 9/30/14 [24]	ra DOE	25	33	35	38	39	41	43	45	47	50	170	396
12. Extension of Customs User Fees [24]:													
a. Extend passenger and conveyance processing fee through 9/30/14	DOE	105	331	348	365	383	402	423	444	466	489	1,532	3,756
b. Extend merchandise processing fee through through 9/30/14	DOE	679	1,234	1,308	1,386	1,470	1,558	1,651	1,750	1,855	1,967	6,077	14,858
13. Prohibition on nonrecognition of gain through complete liquidation of holding company	doo/a DOE	13	15	17	19	21	23	25	27	29	31	85	220
14. Effectively connected income to include economic equivalents of certain categories of foreign-source income	tyba DOE	5	7	8	9	10	10	10	10	11	11	39	91
15. Recapture of overall foreign losses on sale of controlled foreign corporation stock	DA DOE	3	7	8	9	9	9	10	10	10	10	36	85

Provision	Effective	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2005-09	2005-14
16. Recognize cancellation of indebtedness income realized on satisfaction of debt with partnership interest	coio/a DOE	4	4	4	4	5	5	5	5	6	6	21	48
17. Deny installment sale treatment for all readily tradable debt	soo/a DOE	51	57	8	11	12	13	15	17	18	19	139	221
18. Modify treatment of transfers to creditors in divisive reorganizations	to/a DOE	8	9	10	10	10	11	11	12	12	12	47	105
19. Clarify definition of nonqualified preferred stock	ta 5/14/03	5	8	8	8	8	8	8	7	7	7	37	74
20. Modification of definition of controlled group of corporations	tyba DOE	3	5	4	3	2	2	2	1	1	1	17	24
21. Establish specific class lives for utility grading costs	ppisa DOE	13	31	53	72	85	96	106	115	118	118	253	806
22. Provide consistent amortization periods for intangibles	[36]	-152	362	500	521	447	402	345	285	214	161	1,678	3,085
23. Freeze of provision regarding suspension of interest where Secretary fails to contact taxpayer; remove listed and reportable avoidance transactions from interest and penalty suspension	tyba 12/31/03 & iaa 10/3/04	---	23	176	187	188	190	192	195	196	198	574	1,545
24. Increase in withholding from supplemental wage payments in excess of $1 million	pma 12/31/04	111	43	5	[12]	[12]	[12]	4	7	8	8	159	186
25. Capital gain treatment on sale of stock acquired from exercise of statutory stock options to comply with conflict-of-interest requirements	sa DOE	1	1	1	1	1	1	1	1	1	1	4	10
26. Application of basis rules to nonresident aliens	doo/a DOE	14	16	18	21	23	25	27	30	32	35	92	241
27. Limit deduction for certain entertainment expenses (including company-provided aircraft) for covered employees [37]	eia DOE	172	201	209	217	225	234	244	255	264	272	1,023	2,292
28. Modify residence test in U.S. possessions	generally tyea DOE	3	8	12	16	25	35	41	49	58	63	64	310
29. Dispositions of transmission property to implement FERC restructuring policy (with reinvestment obligation (applies to sales or dispositions completed prior to 1/1/07))	ta DOE	-3,147	-1,823	172	939	955	964	970	845	507	15	-2,905	395
30. Expansion of limitation on depreciation of certain passenger automobiles	ppisa DOE	137	136	99	-50	-98	-74	-39	-23	-13	-2	223	71
Total of Revenue Provisions		**611**	**4,135**	**6,987**	**8,257**	**8,845**	**9,482**	**10,255**	**10,838**	**11,158**	**11,388**	**28,835**	**81,966**
NET TOTAL		**-5,690**	**-7,828**	**-4,230**	**2,562**	**6,510**	**2,389**	**1,808**	**1,927**	**1,426**	**1,117**	**-8,678**	**1**

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding. Date of enactment is assumed to be October 15, 2004.

[Legend and Footnotes for JCX-69-04 appear on the following page]

Legend and Footnotes for JCX-69-04:

Legend for "Effective" column:

aa = acquisitions after
ada = amounts deferred after
aoa = acquisitions occurring after
apoamt = amounts paid or accrued more than
asbmpoia = articles sold by the manufacturer, producer, or importer after
ata = actions taken after
ataro/a = amounts treated as received on or after
bi =bonds issued
bia = bonds issued after
bib = bonds issued before
ceia = contracts entered into after
cma = contributions made after
coio/a = cancellations of indebtedness on or after
cpoii = costs paid or incurred in
ctada = contributions, transfers, and distributions after
da = day after
Da = distributions after
DA = dispositions after
di = distributions in
diia = debt instrument issued after
dma = distributions made after
Dma = deposits made after
DMA = designations made after
do/a = disclosures on or after
DOE = date of enactment
doo/a = distributions occurring on or after
Dpa = dividends paid after
eia = expenses incurred after
ematma = elections made and terminations made after
epoia = expenditures paid or incurred after
epoid = expenditures paid or incurred during
fpasoua = fuel produced, and sold or used, after
frsoua = fuel removed, sold or used after
fsa = fuel sold after
fsoua = fuel sold or used after
iaa = interest accrued after
iaeio/a = installment agreements entered into on or after
iwea = individuals who expatriate after
josoa = judgments or settlements occurring after
lf = losses for
pa = production after
Paa = penalties assessed after
PAa = property acquired after
PAb = property acquired before
pada = purchases and dispositions after
pao/a = payments accrued on or after
Pao/a = penalties assessed on or after
pca = productions commencing after
peo/a = positions established on or after
pfa = pleadings filed after
pi = production in
pia = penalties imposed after
pma = payments made after
ppisa = property placed in service after
ra = requests after
rra = risk reinsured after
sa = sales after
saptoea = stock acquired pursuant to options exercised after
soo/a = sales occurring on or after
soea = sales or exchanges after
sota = sales of timber after
ta = transactions after
teia = transactions entered into after
tma = transfers made after
toa = transactions occurring after
to/a = transactions on or after
tpba = taxable periods beginning after
trda = tax returns due after
tyba = taxable years beginning after
tybb = taxable years beginning before
tyea = taxable years ending after
voa = violations occurring after
wma = wagers made after
15da = 15 days after
30da = 30 days after

[1] Includes estimate for general transition and transition for binding contracts, if in effect on September 17, 2003, and for renewals of binding contracts if original contract was in effect on September 17, 2003.
[2] Effective as if included in the amendment made by section 101 of the "Community Renewal Tax Relief Act of 2000."
[3] Gain of less than $1 million.
[4] Effective as if included in the amendment made by section 121(a) of the "Community Renewal Tax Relief Act of 2000."
[5] Loss of less than $500,000.
[6] Effective for debt incurred after date of enactment by SBICs licensed after date of enactment.
[7] The bill provides that the excise tax credit expires after December 31, 2010. If this bill is enacted, the Congressional Budget Office's subsequent baseline would not assume extension of the excise tax credit beyond its expiration because the requirement to assume extension of excise taxes dedicated to trust funds does not apply to excise tax credits paid from the General Fund. For purposes of this revenue estimate, therefore, it is assumed that the excise tax credit would expire as scheduled. This treatment generates changes in revenues after December 31, 2010.
[8] Estimate provided by the Congressional Budget Office. Negative numbers indicate an increase in outlays. Positive numbers indicate a decrease in outlays.
[9] The outlay effects of this provision are the result of indirect effects on outlays for certain farm programs.
[10] The outlay payments for ethanol expire after December 31, 2010.
[11] Tax credits would be provided for on-road and off-road uses of biodiesel.
[12] Gain of less than $500,000.
[13] Provision is effective as if included in the amendments made by section 101 of the Job Creation and Worker Assistance Act of 2002.

[Footnotes for JCX-69-04 are continued on the following page]

Footnotes for JCX-69-04 continued:

[14] Loss of less than $1 million.
[15] Base difference change effective in taxable years beginning after 2004, for taxes paid or incurred after 2004. Basket change in taxable years beginning after 2006. Pre-effective date excess credits carried forward to new basket that would apply under new system.
[16] Effective for taxable years of foreign corporations beginning after December 31, 2004, and for taxable years of U.S. shareholders with or within which such taxable years of such foreign corporations end.
[17] Effective for dividends with respect to taxable years of regulated investment companies beginning after December 31, 2004.
[18] Estimate accounts for interaction with reduction to 2 foreign tax credit baskets.
[19] Effective for excess foreign taxes that may be carried forward to any taxable year ending after the date of enactment. Carryback period effective for credits arising in taxable years beginning after the date of enactment.
[20] Effective for the first taxable year beginning on or after date of enactment, or for the last taxable year beginning before date of enactment, at the taxpayer's election.
[21] Effective for taxable years of a foreign corporation seeking qualified foreign corporation status beginning after September 24, 2004.
[22] Estimate is preliminary and subject to change pending final legislation.
[23] The bill includes additional spending (not shown in the table) that is subject to appropriation.
[24] Estimate provided by the Congressional Budget Office.
[25] Effective dates for provisions relating to reportable transactions and tax shelters: the penalty for failure to disclose reportable transactions is effective for returns and statements the due date of which is after the date of enactment; the modification to the accuracy-related penalty for listed or reportable transactions is effective for taxable years ending after the date of enactment; the tax shelter exception to confidentiality privileges is effective for communications made on or after the date of enactment; the statute of limitations for unreported listed transactions applies to all taxable years for which the statute of limitations under section 6501 has not run as of the date of enactment; the disclosure of reportable transactions by material advisors is effective for transactions with respect to which material aid, assistance or advice is provided after the date of enactment; the investor list penalty is effective for returns the due date for which is after the date of enactment; the modification of penalty for failure to maintain investor lists is effective for requests made after the date of enactment; and the penalty on promoters of tax shelters is effective for activities after the date of enactment.
[26] Effective for all taxable years, whether beginning before, on, or after the date of enactment.
[27] Effective for leases entered into on or after March 12, 2004 with exception for pending transportation leases with FTA.
[28] Generally effective after the date of enactment, except for fuel taxes, effective for taxable years beginning after the date of enactment.
[29] Effective for aviation-grade kerosene removed, entered into the United States, or sold after December 31, 2004.
[30] Effective 180 days after the date on which the Secretary issues the regulations, which are required no later than 180 days after the date of enactment.
[31] Bulk transfers to unregistered parties would be taxed at the time of the transfer. The Secretary would be required to publish a list of certain registered persons by January 1, 2005.
[32] The revenue neutral tax rate on each ten pounds of tire capacity above 3,500 pounds is 9.45 cents on tires in general and 4.725 cents for biasply tires.
[33] Effective for sales in calendar years beginning more than 30 days after the date of enactment.
[34] Effective for vaccines sold and used beginning on the first day of the first month beginning more than four weeks after the date of enactment.
[35] Effective for vaccines sold and used on or after the later of the first day of the first month beginning more than four weeks after the date of enactment, or the date on which the Secretary of Health and Human Services lists the vaccine in the Vaccine Injury Compensation Trust Fund.
[36] Generally effective for start-up and organizational expenditures incurred after the date of enactment.
[37] Applies to individuals subject to section 16 of the Securities and Exchange Act of 1934 for private and public companies.

Welcome (Mostly) Guidance on the New Repatriation Provisions

By Margie Rollinson, Michael Mundaca, and Jose Murillo
Margie Rollinson, Michael Mundaca, and Jose Murillo are members of Ernst & Young's International Tax Services group

I. Summary

On October 22, 2004, President Bush signed into law the American Jobs Creation Act of 2004 (P.L. 108-357). The Jobs Act provides the most sweeping revisions of the tax code since the Tax Reform Act of 1986. Among the numerous changes is the addition of section 965, which makes a fundamental -- although temporary and elective -- change to how the United States taxes dividends paid to U.S. corporations by their overseas subsidiaries.

On January 13, 2005, Treasury and the IRS released Notice 2005- 10, 2005-6 IRB providing the first round of guidance on the repatriation provisions of new section 965. The notice provides guidance on how to satisfy the section's domestic reinvestment requirement, as well as guidance on more general definitional and compliance issues. Specifically, the notice:

- defines the term "cash dividends";
- provides conditions under which dividends paid to partnerships and disregarded entities owned by a U.S. shareholder can qualify under section 965;
- provides guidance on certain permitted and nonpermitted investments (and states explicitly that the expanded list is *not* exclusive);
- provides guidance on developing and implementing the domestic reinvestment plan, including a safe harbor;
- provides procedures for electing section 965;
- provides the reporting and other administrative requirements that the taxpayer must satisfy for the election year and other relevant tax years; and
- provides transition rules for taxpayers that approved domestic reinvestment plans or filed tax returns for their section 965 election year before the issuance of the notice.

The notice is effective for the tax year for which the taxpayer elects to apply section 965 and for any relevant subsequent tax year. The notice provides that all domestic reinvestment plans are subject to the notice, even if the plan describes investments made before January 13, 2005, and even if those expenditures are described in the notice as nonpermitted. However, the notice includes transition rules for U.S. shareholders that approved a plan before the issuance of the notice that may permit the shareholders to amend the plan to meet the requirements of the notice. The notice also provides a transition rule that allows a taxpayer that, before January 13, 2005, filed a tax return for the year for which the taxpayer is electing section 965 to satisfy the reporting requirements of the notice on an amended return filed by the extended due date of the tax return for the tax year already filed.

The notice states that Treasury and the IRS intend to issue additional notices to provide further guidance under section 965, including guidance relating to the foreign tax credit; expense allocation; adjusting the calculation of the base period amount to account for mergers, acquisitions, and spinoffs; and controlled groups. The notice also states that Treasury and the IRS intend to issue regulations that incorporate the guidance provided in Notice 2005-10 and the subsequent notices.

This article begins with an overview of the provisions of section 965 and then addresses in detail Notice 2005-10. For a more in-depth discussion of the provisions of section 965, see Peter H. Blessing's article "Bringing It All Back Home: Repatriations Under the American Jobs Creation Act of 2004," *Tax Notes*, Nov. 15, 2004, p. 965 (also available at *Doc 2004-21522* [**PDF**] or *2004 TNT 221-33*).

II. Discussion

A. Section 965

Section 965 provides corporate U.S. shareholders of controlled foreign corporations an election to claim for one year a deduction equal to 85 percent of cash dividends received in that election year from their CFCs in excess of a base-period amount that reflects the CFCs' dividend-paying history. The 85 percent deduction is available, however, only if the amount of the cash dividends generating the deduction is invested in the United States under a properly approved domestic reinvestment plan (and subject to certain other limitations).[1] The election is available for either the corporate U.S. shareholder's last tax year that begins before October 22, 2004, or the first tax year that begins during the one-year period beginning on October 22, 2004. Section 965(f) requires the election to be made before the due date (including extensions) for filing the tax return for the election year. (The conference report to the Jobs Act provides that the election is to be made on a timely filed return -- including extensions -- for the tax year for which the election is made).[2] For the repatriation provision, all U.S. shareholders that are members of an affiliated group filing a consolidated return are treated as one U.S. shareholder.[3]

A dividend under section 965 does not include amounts treated as dividends under sections 78, 367, or 1248, nor does it include subpart F inclusions or amounts included in income under section 956.[4] The exclusion of dividends under section 367 does not apply, however, in the case of a liquidation described in section 332 to which section 367(b) applies to the extent that cash is actually received by the U.S. shareholder as part of the liquidation.[5] Also, cash distributions of previously taxed subpart [P. 445]F income (PTI) received by the U.S. shareholder in the election year from a top-tier CFC are treated as cash dividends to the extent of the U.S. shareholder's subpart F inclusions in that year resulting from a cash dividend in that year to that top-tier CFC from a lower- tier CFC (in a section 958(a) chain of ownership) or a cash dividend to any other CFC in that chain to the extent of cash distributions paid up through the chain of ownership.[6]

The CFC cash dividend amount eligible for the 85 percent deduction is limited to the greater of $500 million or the amount shown on the applicable financial statement as earnings permanently reinvested outside the United States (the APB 23 amount) (or if a specific APB 23 amount is not shown but a specific amount of tax liability attributable to the APB 23 amount is shown, the amount equal to such liability divided by 0.35).[7] For a U.S. shareholder required to file a financial statement with the Securities and Exchange Commission, the applicable financial statement is the most recent financial statement filed on or before June 30, 2003.[8]

The CFC cash dividend amount eligible for the 85 percent deduction is further limited to the amount that election year dividends exceed the corporate U.S. shareholder's average annual repatriations from CFCs over the last five most recent years ending on or before June 30, 2003,[9] disregarding the high and low years (the base-period amount). The following amounts are considered in calculating the base-period amount:

- cash and noncash dividends received by the corporate U.S. shareholder from CFCs;
- amounts included in income by the corporate U.S. shareholder under section 951(a)(1)(B) (that is, section 956 inclusions); and

- CFC distributions received by the corporate U.S. shareholder excluded from income under section 959(a) (that is, distributions of PTI other than PTI distributions attributable to section 956 inclusions during a base-period year already taken into account).[10]

Note that some amounts taken into account in determining the base-period amount are not considered in determining the CFC cash dividend amount eligible for the 85 percent deduction. For example, although section 956 inclusions during the base period increase the base-period amount (and therefore increase the amount of fully taxable dividends that must be paid during the election year before excess CFC cash dividends can generate the 85 percent deduction), section 956 inclusions in the election year are *not* considered dividends for purposes of meeting the base-period amount (or generating the 85 percent deduction).

The CFC cash dividend amount eligible for the 85 percent deduction is further reduced by any increase in related-party indebtedness of the CFC occurring between October 3, 2004, and the close of the tax year for which the deduction is being claimed.[11] All CFCs for which the taxpayer is a U.S. shareholder are treated as one CFC for that purpose. The conference report to the Jobs Act explains that the provision is "intended to prevent a deduction from being claimed in cases in which the U.S. shareholder directly or indirectly (for example, through a related party) finance the payments of a dividend from a controlled foreign corporation" and thus, there is "no net repatriation of funds."

Finally, section 965(b)(4) requires that the amount of CFC cash dividends generating the 85 percent deduction be invested in the United States under a plan providing for reinvestment of that cash dividend in the United States. The domestic reinvestment plan (DRIP) must be approved by the corporate U.S. shareholder's president, CEO, or comparable official before payment of the dividend, and must be subsequently approved by the corporate U.S. shareholder's board of directors, management committee, executive committee, or similar body.[12] Section 965 specifies that a DRIP may provide for the reinvestment of the cash dividends in the United States as a source of funding for worker hiring and training, infrastructure, research and development, capital investments, and "the financial stabilization of the corporation for the purposes of job retention or creation."[13] The cash dividend cannot, however, be used as a payment for executive compensation.

We should note that the Tax Technical Corrections Act of 2004, introduced in Congress on November 19, 2004 (H.R. 5395 and S. 3019), included several proposed corrections to section 965. It is expected that the bill will be reintroduced shortly and perhaps modified. The guidance provided in Notice 2005-10 does not implicate any proposed corrections, so we do not discuss them in this article.

B. Notice 2005-10

1. Cash dividend. The notice clarifies that for purposes of section 965, cash includes both U.S. dollars and foreign currency, but does *not* include cash equivalents, as defined in reg. section 1.897-7T(a). The notice states that Treasury and the IRS anticipate that in some cases, CFCs will be required to liquidate cash equivalents to pay a cash dividend to the electing U.S. shareholder and that the electing U.S. shareholder may temporarily invest the CFC cash dividend in similar cash equivalents. The **[P. 446]** notice provides that the temporary reinvestment will not itself require the application of step transaction principles (or similar authorities) to recast the dividend as a distribution of cash equivalents.

The notice's definition of cash for purposes of section 965 could have significant U.S. federal tax implications for electing U.S. shareholders with CFCs that must liquidate cash equivalents with built-in gains to pay a dividend. For example, if any gain recognized by the CFCs from liquidating cash equivalents creates a subpart F inclusion for the corporate U.S. shareholder, not only would the shareholder have income subject to full U.S. taxation, but the amount of a subsequent cash distribution from the CFC that could otherwise be treated as a qualifying cash dividend under section 965 would be

reduced by the amount of the subpart F inclusions (because the subpart F inclusion would create PTI under section 959 that would, under the ordering rules of section 959(c), be considered distributed to the U.S. shareholder before any nontaxed earnings and profits; as will be discussed below, the notice clarifies that except as otherwise provided in section 965(b)(4), PTI distributions are not "dividends" for purposes of section 965 and thus are not eligible to generate the 85 percent deduction).

The notice confirms that dividends described in section 356(a)(2) qualify as dividends for purposes of section 965. The Jobs Act conference report explicitly provides that cash amounts treated as dividends under section 302 or 304 are cash dividends for purposes of section 965, but did not explicitly address section 356.[14]

2. Distributions to intermediary passthrough entities. The notice provides that the electing U.S. shareholder will be treated as receiving a CFC cash dividend paid to a partnership (foreign or domestic) or disregarded entity (DE) only if, and to the extent that, the electing U.S. shareholder receives cash "in the amount of" the CFC cash dividend from the partnership or DE during the election year. For partnerships, the notice further requires that the CFC cash dividend be allocated to the U.S. shareholder under sections 702 and 704 (and the regulations thereunder) and that the dividend be separately stated by the partnership to that partner under reg. section 1.702-1(a)(8)(ii). Finally, the notice clarifies that a loan of cash from a DE to the electing U.S. shareholder will not satisfy the distribution requirement, because the shareholder would be obligated to repay the cash to the DE.

The additional requirements imposed by the notice for CFC cash dividends received through passthrough entities could have a substantial effect. For example, regarding partnerships, if the partnership agreement does not currently provide for cash distributions or for the allocation of the relevant CFC cash dividends to the U.S. partner, the partnership agreement would have to be amended, which could materially affect the economic agreement of the partners. Amending the partnership agreement could prove difficult in the case of a joint venture between unrelated parties. For DEs, the requirement that cash be distributed, as opposed to loaned, to the electing U.S. shareholder would create an additional cash cost if the cash distribution were subject to foreign withholding tax. It must also be determined whether the country of incorporation of the DE imposes any limits on amounts distributed to shareholders.

We should note that the rules provided in the notice cover only distributions to partnerships and DEs owned by U.S. shareholders, and do not explicitly cover distributions to other passthrough entities. Thus, for example, the notice does not explicitly cover dividends or other distributions paid to passthrough entities owned by CFCs, although there appear to be no technical or policy reasons why the rule should not apply in that context as well. Therefore, for example, a dividend paid by a CFC to a partnership owned by another CFC that would be eligible for the chain dividend rule if paid directly should be eligible if the partnership distributes the amount of the dividend to the CFC partner. Treasury and the IRS should confirm that in future guidance.

3. Amount of CFC cash dividend. The notice clarifies that the amount otherwise qualifying as a cash dividend is not reduced by expenses or deductions of the taxpayer related to the dividend, including any foreign withholding taxes. Thus, if a CFC distributes a $100 cash dividend to its U.S. shareholder and that dividend is subject to $5 foreign withholding tax (so that the U.S. shareholder receives only $95 cash), the amount of the cash dividend for purposes of section 965 is $100. The notice also clarifies that the electing U.S. shareholder must invest the gross amount of CFC cash dividends (not reduced by expenses or deductions related to that amount, including any foreign withholding tax) for the total CFC cash dividend to qualify for the 85 percent deduction. Therefore, if the electing U.S. shareholder receives a CFC cash dividend of $100 that is subject to foreign withholding tax of $5, the shareholder must invest $100 in the United States under the DRIP to claim an $85 deduction.

That clarification -- along with the rule described in further detail below providing that payment of foreign taxes is not a permitted investment -- will require the electing U.S. shareholder to use other cash (not provided by the CFC cash dividend) to satisfy the reinvestment requirement.

4. PTI distributions under section 959. The notice confirms that only cash PTI distributions described in section 965(a)(2) (the so-called chain or indirect dividend rule) are treated as dividends for purposes of section 965. To illustrate the limitation, the notice explains that if a CFC has a PTI account of 100u (not otherwise eligible under section 965(a)(2)), and nontaxed E&P of 50u, the CFC must distribute 150u to its U.S. shareholder to be treated as having paid a 50u dividend for purposes of section 965.

5. Domestic reinvestment plan. The notice establishes general principles for developing and implementing the DRIP and also provides guidance regarding its content and specificity. Specifically, the notice clarifies that the DRIP must be a written plan prepared by the taxpayer and describe the planned U.S. investment of the amount of CFC cash dividends in "reasonable detail and specificity." The DRIP may include more than one cash dividend from more than one CFC. Alternatively, the electing U.S. shareholder may adopt a separate DRIP for [P. 447] separate CFC cash dividends received during the election year. The notice also confirms there is no incremental investment requirement; that is, the DRIP investments need not exceed investments that were planned by the taxpayer before the enactment of section 965.

Regarding approval of the DRIP, the notice provides that if the electing U.S. shareholder is a member of a consolidated group, the DRIP must be approved by the appropriate corporate officer and board of directors of the common parent of the group. In that case, the separate members of the group are not required to separately approve the DRIP, even if those members make the permitted investments described in the DRIP.

a. Specificity requirement. The notice provides that the DRIP must describe "specific anticipated investments in the United States" and must provide sufficient detail to permit the electing U.S. shareholder to demonstrate that the subsequently incurred expenditures were in fact contemplated when the DRIP was adopted. Therefore, the notice provides that a DRIP that merely recites the statutory language of section 965 or that merely refers generically to the investments that may be permitted for purposes of section 965 will not have met the requirements for a qualified DRIP.

The DRIP, however, is not required to indicate the exact dollar amounts to be incurred for each specific component of a permitted investment, but rather can state the total amount that will be invested for each respective principal investment. For example, the notice provides that the DRIP could indicate a total dollar amount for R&D expenditures for several specific product lines and a total amount for advertising expenditures for several specific brands (and need not break out expenditures for product lines or brands). Also, the notice provides that the electing U.S. shareholder is permitted to shift actual expenditures between the permitted investments specified in the DRIP without amending the DRIP. Amounts shifted would be considered spent on alternative investments indicated in the DRIP (see discussion below).

b. Timing of investment and investment alternatives. The notice provides that the DRIP must state a "reasonable time period" during which the taxpayer anticipates completing all investments under the DRIP. The notice, however, indicates that Treasury and the IRS recognize that after adoption of the DRIP, some specified investments may be delayed or rejected. For that reason, the notice permits the electing U.S. shareholder to list alternative permitted investments that will be funded by the CFC cash dividend if the principal investments are delayed or rejected. The alternative investments must be described under the same specificity standard described above; however, the DRIP is not required to describe the conditions under which the alternative investments will be substituted for the principal investments.

As noted immediately below, a DRIP cannot be amended once the dividend to which it relates is paid; moreover, any alternative permitted investments must be described in the DRIP. Thus, for example, suppose a taxpayer approved a DRIP covering a $100 million dividend providing for a $100 million acquisition of a plant in Ohio, and alternatively a $100 million U.S. R&D expenditure for a new drug. If the taxpayer later discovered that the Ohio plant could not be acquired, the taxpayer could instead use the $100 million to fund the R&D. However, if the DRIP had not described the R&D as an alternative permitted investment, the $100 million dividend would *not* qualify as being used for a permitted investment, even if actually used to fund U.S. R&D, and the $100 million dividend received would *not* be eligible for the section 965 deduction.

c. Amending the DRIP. Except as permitted by the transition rules included in the notice (discussed below), the DRIP cannot be modified or amended after the payment of the CFC cash dividend to which it relates.

d. Tracing or segregating funds. The notice confirms that the electing U.S. shareholder is not required to trace or segregate the CFC cash dividend proceeds to demonstrate that it has invested the amount of the CFC cash dividend under the DRIP. The notice also clarifies that nonpermitted investments made during the period covered by the DRIP will not affect the eligibility of the CFC cash dividend under section 965, provided the electing U.S. shareholder can demonstrate that it has invested the amount of CFC cash dividends covered by the DRIP. However, if the DRIP is to be implemented over a period of many years, the notice indicates that a segregated account in the amount of the CFC cash dividends, with disbursements from the account used for the investments described in the DRIP, would be a positive factor in establishing that the U.S. investment requirement has been met.

e. Investments contemplated before adoption of the DRIP. The notice provides that the DRIP may include a permitted investment that was anticipated by the electing U.S. shareholder before adoption of the DRIP, even if that investment was budgeted for and expected to be made with other funds.

f. Expenditures during the election year. The notice provides that all permitted investments made during the election year may be considered made under the DRIP even if those investments are made before adoption of the DRIP and payment of the CFC cash dividends. However, expenditures made before the election year will not qualify as permitted investments made under the DRIP.

g. Partially completed DRIPs. The notice provides that if less than the full amount of the CFC cash dividends is properly invested, the amount of CFC cash dividends that will qualify for the 85 percent deduction will be reduced proportionately. For example, if the amount actually used to make permitted investments equals 90 percent of the amount of CFC cash dividends included in the DRIP, only 90 percent of the otherwise eligible CFC cash dividends will generate the 85 percent deduction.

6. Permitted U.S. investments. The notice further describes the permitted investments listed in section 965(b)(4)(A) and identifies additional permitted investments. The notice also clarifies that all investments under the DRIP must be made in cash and paid to persons who are not related to the electing U.S. shareholder within the meaning of section 267(b), other than section 267(b)(8) (regarding fiduciaries of a trust). The notice states that if the electing U.S. shareholder issues a note in payment of [P. 448]a permitted investment, the shareholder will be treated as making the investment only as the debt obligation is satisfied with cash.

a. Funding of worker hiring, training, and other compensation. The notice provides that permitted investments include expenditures for the funding of worker hiring and training, which in general includes expenditures incurred in connection with hiring new workers, training both existing and newly hired workers, and on compensation and other benefits (including funding a qualified benefit plan as defined in section 401(a)) for existing and newly hired workers. Expenditures for similar uses on workers who are

not employees of the electing U.S. shareholder also qualify. In all cases, however, expenditures will qualify only to the extent attributable to services performed by the workers in the United States. The electing shareholder must apply the principles of Treas. reg. section 1.861-4(b)(1) to determine the U.S. component of services performed partly within and partly outside the United States. Finally, the electing shareholder must use a reasonable method to apportion the amount used to fund a qualified plan between amounts related to permitted and nonpermitted compensation and between amounts related to U.S. and non-U.S. based services.

The rule allowing expenditures incurred on compensation and benefits of existing workers to be a permitted investment is especially generous.

b. Infrastructure and capital investments. The notice provides that qualifying expenditures for infrastructure and capital investments include physical installations and facilities that support the electing U.S. shareholder's business; plant, property and equipment; communications and distributions systems, computer hardware and software, and databases and supporting equipment; any other assets that are integral to the conduct of that business; and any capital improvements to those assets. In all cases, however, only assets located and used in the United States will qualify. If the infrastructure or capital investment is located partly within and partly without the United States, the electing U.S. shareholder must identify the amount of assets located and used within the United States. The notice also clarifies that expenditures for the assets described in the notice will qualify regardless of whether the expenditures are incurred to construct, develop, purchase, rent, or license the assets.

c. R&D expenditures. The notice provides that qualifying R&D expenditures are those expenditures described in reg. section 1.174-2, but only to the extent that the R&D activities are performed in the United States. The electing U.S. shareholder must apply the principles of reg. section 1.861-4(b)(1) to determine the qualifying amount of R&D activities (and the corresponding R&D expenditures) performed partly within and partly without the United States. Expenditures for R&D activities not performed by employees of the electing U.S. shareholder are permitted to the extent the expenditures are in fact borne by the electing U.S. shareholder. The amount of qualifying R&D expenditures is reduced to the extent the electing U.S. shareholder is reimbursed under a cost-sharing agreement described in reg. section 1.482-7.

d. Financial stabilization of the corporation for purposes of job retention or creation. The notice identifies debt repayment and funding of qualified benefit plans as permitted investments that could contribute to the financial stabilization of the electing U.S. corporate shareholder for job retention or creation. The notice also indicates that other expenditures could contribute to the financial stabilization of the shareholder depending on all facts and circumstances, including, for example, if the expenditure reduces the financial constraints on the shareholder's U.S. operations and if, at the time the DRIP is approved, the electing U.S. shareholder's reasonable business judgment is that the reduction "will be a positive factor in its ability to retain and create jobs in the United States."

i. Debt repayment. The notice provides that debt repayment will ordinarily be considered to contribute to the financial stabilization of the electing U.S. shareholder because the repayment improves the shareholder's debt-equity ratio and reduces the shareholder's obligations for debt service. An increase in the shareholder's credit rating because of the debt repayment is not required. However, the notice states that a credit rating increase would be an indication of a contribution to financial stabilization. The financial stabilization from debt repayment will be considered to be for the purposes of U.S. job retention or creation if when the DRIP is approved, the electing U.S. shareholder's "reasonable business judgment" is that the financial stabilization will be a positive factor for the retention or creation of U.S. jobs. In that regard, the notice provides that a plan developed by the electing U.S. shareholder as part of its strategic planning process indicating that savings attributable to reduced debt service are expected to be used in connection with permitted investments is one method for demonstrating a purpose of U.S. job retention or creation. The notice provides, however, that debt repayment is not a permitted investment to the extent

that, at the time of the repayment, the electing U.S. shareholder has a plan or intent (based on all facts and circumstances and general tax principles, including substance-over- form principles) to incur additional debt on substantially the same terms following the receipt of the CFC cash dividend and, in fact, incurs that additional debt. Finally, the notice provides that the electing shareholder is not required to demonstrate that there has been a net global debt reduction; therefore, the U.S. shareholder's CFCs may incur debt to pay cash dividends that will be used by the U.S. shareholder for debt repayment. In all cases, however, the repayment or acquisition of an intercompany obligation between members of the same consolidated group will not qualify unless the member receiving the cash makes a permitted investment of that amount under the DRIP.

ii. Qualified plan funding. The notice provides that satisfying an obligation to fund a qualified benefit plan described in section 401(a) ordinarily will contribute to the financial stabilization of the electing shareholder. For that purpose, the electing shareholder is not required to demonstrate the extent to which the benefit plan covers current employees or the extent to which covered employees perform (or performed) services in the United States. The notice further provides that the financial stabilization provided by the funding of a qualified benefit plan will be treated as contributing to U.S. job creation or retention if, when the DRIP is approved by an [P. 449]executive officer of the shareholder, the shareholder's "reasonable business judgment" is that the financial stabilization will be a positive factor in the shareholder's ability to retain and create U.S. jobs.

e. Acquisitions of interests in business entities. The notice provides that the direct or indirect acquisition of at least a 10 percent interest (by value) in a domestic or foreign business entity (for example, a corporation or partnership) is a permitted investment to the extent of the percentage of the total value of the assets owned (directly and indirectly) by the business entity that if acquired directly by the electing shareholder would be permitted investments. Rules similar to those of section 267(c) apply to determine whether the 10 percent interest requirement is met.

The acquisition price for a direct interest in a business entity must be allocated between permitted and nonpermitted investments on the basis of the relative values of the business entity's assets. For that purpose, the electing U.S. shareholder must use the same method used to allocate and apportion interest expense for the election year under section 864(e). Whether assets are permitted or nonpermitted is based on the location of the assets, not on the source of income generated by the assets. Note however, that if more than 95 percent of the acquired business entity's assets would be permitted or nonpermitted, the entire acquisition will be treated as permitted or nonpermitted, respectively.

f. Advertising and marketing expenditures. The notice provides that advertising and marketing expenditures for trademarks, trade names, brand names, or similar intangible property are permitted investments if the advertising and marketing activities are performed in the United States. The principles of reg. section 1.861- 4(b)(1) must be applied to determine the amount of activities performed partly within the United States and that partly qualify as permitted investments. Like R&D expenditures, advertising and marketing expenditures must be borne by the electing shareholder, but employees of the electing U.S. shareholder need not perform the advertising and marketing activities.

It is unclear what advertising expenditures were meant to be excluded by limiting the permitted investment to advertising "with respect to trademarks, trade names, brand names, or similar intangible property." Taxpayers may need to consider carefully whether their advertising meets those requirements.

g. Acquisition of intangible property. The notice provides that expenditures for the purchase or license of intangible property are permitted investments to the extent the rights to the intangible property are used in the United States.

7. Nonpermitted investments.

a. Executive compensation. The notice defines executive compensation as compensation paid, directly or indirectly, by or on behalf of the electing U.S. shareholder to any employee or former employee in exchange for services (past, present, or future) performed for the shareholder, if (1) the employee is subject to the requirements of section 16(a) of the Securities Exchange Act of 1934 (the Securities Act) regarding the electing U.S. shareholder; (2) the employee would be subject to section 16(a) of the Securities Act if the electing shareholder issued securities referred to in section 16(a) of the Securities Act; or (3) the individual is a former employee who was subject to section 16(a) of the Securities Act (or would have been subject to if the electing U.S. shareholder had issued relevant securities) at the time of the severance of employment. For that purpose, the electing U.S. shareholder is permitted to identify the 10 employees with the highest wages in the most recently ended calendar year as the individuals described in requirement (2) above.

b. Intercompany transactions. The notice provides that intercompany transactions (as defined in reg. section 1.1502-13) between corporations that are members of the same consolidated group are not permitted investments.

c. Acquisition of debt instruments. The notice provides that the acquisition of a debt instrument or other evidence of indebtedness is not a permitted investment.

d. Distributions regarding stock. The notice provides that dividends and other distributions made by the electing U.S. shareholder to its shareholders with respect to its stock are not permitted investments. Moreover, a distribution with respect to the stock of a consolidated group member that is held by a person that is not a member of the same consolidated group is not a permitted investment.

e. Stock redemptions. The notice provides that the redemption of outstanding stock of the electing shareholder or of a related corporation is not a permitted investment. Thus, funding a stock buyback program is not a permitted investment.

f. Portfolio investments in business entities. Except as otherwise provided by the notice (see the discussion above regarding acquisition of interests in specified business entities), the acquisition of an interest in a business entity is not a permitted investment.

g. Tax payments. The notice provides that payments of federal, state, local, or foreign taxes and associated interest and penalties, including foreign withholding tax and domestic taxes imposed on the CFC cash dividends, are not permitted investments.

8. Election procedures. The notice provides that the U.S. corporate shareholder elects to apply section 965 by filing Form 8895 with its timely filed tax return (including extensions) for the election year. If the electing shareholder files its tax return for the election year before issuance of Form 8895, the notice provides that the taxpayer must make the election by attaching a statement to its timely filed tax return for the election year. Form 8895 had not been released as of the date of issuance of the notice.

9. Reporting and other administrative requirements. The notice adopts some other reporting and administrative requirements that the electing U.S. shareholder must satisfy.

a. Annual reporting and documentation requirements. The notice requires the electing shareholder to provide an information statement to report, in part, the completion of the DRIP (on a percentage basis) and whether the amount of the CFC cash dividends has been invested in primary or alternative permitted investments. The information statement must be attached to the electing shareholder's timely filed tax return (including extensions) for the election year and for each subsequent [P. 450] tax year at the

beginning of which all investments required to be made under the DRIP have not been made. See section 8.02 of the notice for a complete listing of the information that must be included in the statement.

b. Satisfaction of investment requirement. In general, whether the amount of the CFC cash dividends has been invested in the United States under the DRIP depends on the facts and circumstances of the electing U.S. shareholder. The notice includes a list of facts and circumstances that will be considered for that purpose.

The notice also provides a safe harbor under which the electing shareholder will be considered to have established to the satisfaction of the commissioner that the amount of the dividend has been invested in the United States under the DRIP as required under section 965(b)(4). The requirements of the safe harbor are:

- at least 60 percent of the amount of permitted investments (as listed in section 5 of the notice) covered by the DRIP must have been made (or be the subject of a binding contract or commitment with unrelated parties) by the end of the second tax year following the election year (although for those purposes, permitted investments made for the purpose of financial stabilization include only debt repayment and qualified plan funding);
- the electing shareholder must meet the annual reporting requirements discussed immediately above and include in that reporting the additional representations listed in section 8.03(c) of the notice, including a representation that the taxpayer intends to make the amount of the investments under the DRIP no later than the end of the fourth tax year following the election year, and including representations specific to debt repayment and funding of qualified plans; and
- the electing shareholder must meet the recordkeeping requirements discussed immediately below.

c. Recordkeeping. The notice requires the taxpayer to maintain records that display in reasonable detail the amount invested in the United States under the DRIP; a copy of the DRIP and any supporting documents; and documents supporting the qualification of CFC cash dividends received through certain foreign partnerships.

10. Transition rules. The notice is effective for the tax year for which a taxpayer elects to apply section 965 and for any relevant subsequent tax year. The notice includes transition rules for U.S. shareholders that have elected to apply section 965 before January 13, 2005, or have filed tax returns for the election before January 13, 2005. Specifically, the electing shareholder is permitted to modify any DRIP approved before January 13, 2005, that does not conform to the requirements of the notice even if the dividend (or dividends) to which the DRIP relates has already been paid. The DRIP must be modified no later than March 14, 2005, and subsequently approved. Also, any electing shareholder that has filed its tax return for the election year before January 13, 2005, is permitted to satisfy the reporting requirements of the notice on an amended tax return filed by the due date (including extensions) of the tax return for the election year.

III. Conclusion

Notice 2005-10 provides welcome guidance regarding the repatriation provisions of section 965, and is mostly good news for taxpayers. Although some may be disappointed that stock redemptions and dividend payments are not permitted investments and that cash equivalents are not considered cash, the notice does provide some very generous rules regarding permitted investments, including broad rules on worker compensation and benefits, debt repayment, qualified plan funding, business acquisitions, and advertising. The notice also provides rational and administrable rules regarding the development and implementation of the DRIP, as well as reasonable general administrative and compliance rules.

FOOTNOTES

[1] Section 965(b)(1)-(4).
[2] *See* American Jobs Creation Act of 2004, Conference Report, H.R. Rep. No. 108-755, at 302 n. 107 (hereinafter "conference report").
[3] Section 965(c)(5)(A).
[4] Section 965(c)(3).
[5] *Id.* The conference report provides, however, that "a deemed liquidation effectuated by means of a 'check the box' election under the entity classification regulations will not involve an actual receipt of cash that is reinvested in the United States as required for purposes of this provision." Conference report at 302 n. 108.
[6] Section 965(a)(2) (the so-called "chain dividend rule").
[7] Section 965(b)(1).
[8] Section 965(c)(1).
[9] Section 965(c)(2)(A). However, section 965(c)(2)(B) provides that if the corporate U.S. shareholder has fewer than five tax years ending on or before June 30, 2003, the base period includes all of the tax years of the corporate U.S. shareholder ending on or before June 30, 2003. Also, section 965(c)(2)(C)(ii) provides detailed guidance regarding the effect of some spinoffs on that determination.
[10] Section 965(b)(2)(B).
[11] Section 965(b)(3).
[12] Section 965(b)(4)(A).
[13] Section 965(b)(4)(B). The conference report makes clear that "the list of permitted uses is not exclusive." Conference report at 303.
[14] *See* conference report at 302.

The US government's decision to allow US companies to repatriate earnings took an unexpected turn today with the Treasury Department's release of Section 965(a). This section details the American Jobs Creation Act of 2004, which allows corporations that are US shareholders of controlled foreign companies to elect, for one taxable year, an 85 percent dividends received deduction regarding certain cash dividends from such companies.

The Treasury Department's release includes restrictions on the amount of earnings that companies will be allowed to repatriate. However, in our view, the surprise comes from the section of the release providing requirements on the manner in which repatriated earnings must be spent. Specifically, according to the release, the senior management and boards of companies repatriating earnings must approve a "reinvestment plan" providing for the investment of the funds in the US, such as "the funding of worker hiring and training, infrastructure, research and development, capital investments, or the financial stabilization of the corporation for the purposes of job retention or creation." The release states that companies may use their repatriated earnings to pay down their debt. However, repatriated earnings may not go toward executive compensation, dividend payments to shareholders, share buybacks, and other uses. The original legislation was worded loosely enough to allow some of these possible uses.

Many analysts and corporations expected that repatriated earnings through the American Jobs Creation Act of 2004 would end up funding shareholder-friendly behavior. JPMorgan had conducted a poll of 28 firms in May 2003 in which firms could mention more than one way in which they would be likely to use their repatriated earnings. In the poll, 18% said they would use repatriated earnings to buy back stock and 11% said they would pay out their funds as dividends. In that poll, however, the highest percentage (46%) said that they would use their repatriated earnings to pay down their outstanding debt. Approximately 39% said they would use the funds for capital spending, and another 39% said they would use it for research and development. Thus most of the respondents said they would use their repatriated earnings in ways that remain eligible following Section 965(a).

At first glance, Section 965(a) should be good news for credit investors; companies that planned to repatriate earnings to pay down the debt still will be able to do so, and repatriated earnings that may otherwise have been used to fund shareholder-friendly activity now are more likely to be used for balance sheet repair or capital investment. The potential for companies to repatriate as much as $320 billion of earnings in the span of one year remains. If such funds are earmarked for debt reduction, not only would corporate

creditworthiness improve (no bad thing for credit investors), but also the technical imbalance between supply and demand of corporates that has been so supportive of spreads could intensify.

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Bringing It All Back Home: Repatriations Under the American Jobs Creation Act of 2004

By Peter H. Blessing

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Blessing believes that one of the most significant provisions in the American Jobs Creation Act of 2004 is new code section 965, which allows U.S.-based multinationals the right to elect for one tax year to repatriate cash from CFCs and claim an 85 percent dividends received deduction in respect of previously untaxed earnings. Whether a U.S. group would find it advantageous to avail itself of the provision depends on a number of tax and nontax considerations, according to Blessing. This article focuses on the requirements for meeting the conditions of the legislation, issues to be sensitive to, and planning in an uncertain environment pending guidance from Treasury and the IRS. This article is adapted from a longer paper originally presented at the Tax Club meeting in New York on October 25, 2004.

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I. Introduction and Overview of Statute

Depending on one's perspective, the international provisions of the American Jobs Creation Act of 2004[1] represents enlightened legislation or trick or treat time come early. Among the international provisions, new section 965 (Temporary Dividends Received Deduction) is one of the more remarkable, for several reasons. First, it is acknowledged to be fundamentally inconsistent with the framework of the U.S. system governing overseas earnings that has been in place since the 1960s and the underlying policies. Notwithstanding that inconsistency, Congress has expressly stated that no change in policy is intended and the relief will be a one- time event[2] (thus making the provision deadwood within a relatively short period). In addition, the magnitude of the sums potentially involved is staggering. Further, as we shall see, even more than the norm for the legislative process, the drafters may not have been allowed full rein to link the statutory requirements to the stated goals. Finally, although the provision incorporates novel concepts, there is no express grant of regulatory authority, antiabuse or [P. 966] otherwise, so only interpretive guidance from Treasury and the IRS is contemplated.

This report will not enter the fray concerning the merits of section 965[3] but instead will provide some initial thoughts on technical issues raised by the legislative language and related planning considerations.

Because of the short time for taxpayers to avail themselves of section 965 and the disastrous consequences of being wrong, Treasury and the IRS are under pressure to issue prompt guidance. The time frame seems inadequate to accommodate guidance under a normal regulatory project. Proceeding at least in the first instance by Notice providing guidance and requesting comments supplemented by revenue ruling guidance seems the more suited approach. In addition, as noted herein, technical corrections to the statute appear necessary in at least two respects.

Section 965, in a nutshell, permits a corporation that is a United States shareholder (USSH) of a controlled foreign corporation a one-time election, for one of two tax years to be chosen by the USSH, to repatriate selected low-tax earnings from the CFC and be taxed on the basis of an 85 percent dividends received deduction (effectively, a 5.25 percent federal income tax rate before credit, if any). The provision is subject to requirements and limitations as follows:

(i) Timely election must be made on the return (including extensions).
(ii) Dividend claimed must be actually repatriated in cash and taxed under U.S. principles as a dividend (or be excluded under section 959(a) and be attributable to a same-year subpart F income inclusion resulting from a CFC to CFC dividend).
(iii) Amount of qualifying dividend is reduced by any increase in indebtedness of the CFCs (taken together), with respect to which the taxpayer is a USSH, to a related person as defined in section 954(d)(3) other than another CFC, measured from the close of October 3, 2004 to the close of the tax year for which the section 965 election is in effect.
(iv) Dividends treated as qualifying cannot exceed the greater of $500 million or the amount of income shown on a specified financial statement as permanently invested outside the United States.
(v) Dividends are treated as qualifying only to the extent the total qualifying and nonqualifying dividends received by the USSH from all CFCs (in the aggregate) during the tax year of the election exceed the USSH's average amount repatriated from all such CFCs during a base period. The base period generally is three of the five most recent tax years ending on or before June 30, 2003, determined by disregarding the years with the highest and lowest repatriation amounts.
(vi) The amount of the qualifying dividend must be invested in accordance with a "domestic reinvestment plan" (DRIP) that is timely approved and provides for the reinvestment of the dividend "in the United States" (other than as payment of executive compensation).

There is no requirement that a CFC have been in existence for any particular length of time or have engaged in any particular activity. That is consistent with the purpose of the statute (and is appropriate, as illustrated by the example of earnings and profits moving to a newly formed finance company in the same jurisdiction). There is also no requirement that a foreign corporation have been a CFC before the tax year for which the election is made[4] or even have been owned to any extent by the USSH before that year.

Whether section 965 is beneficial to a particular taxpayer depends on a host of factors, including (1) the effective tax rates of overseas earnings, (2) the ability to target certain effective tax rates in the context of an actual dividend considering the taxpayer's CFC structure, (3) the feasibility of funding a dividend, (4) local tax restrictions on paying a dividend, (5) the presence or absence of minority shareholders, (6) local withholding tax, (7) state tax consequences, (8) the effect on reported earnings, and (9) the intended use for the funds. The benefit and burden analysis of whether to repatriate earnings under section 965 is, however, not the subject of this report.

The balance of this report discusses the section 965 requirements and limitations and the tax regime created by section 965.

II. Election

In general, the election is available to any corporate USSH of a CFC. A USSH is any U.S. person (as defined in section 957(c)) that owns, directly or constructively under section 958, 10 percent or more of the combined voting power of a foreign corporation. Section 951(b). For that purpose, all USSHs that are members of an affiliated [P.

967] group filing a consolidated federal income tax return are treated together as a single USSH. Section 965(c)(5)(A).

Presumably as a result of the conception of the provision as a measure to enhance domestic investment, the provision is available only to corporate USSHs. For example, it is not available to a domestic partnership that conducts operations in the United States and abroad through CFCs. It, however, would be applicable to, for example, a domestic corporation that holds an interest in a partnership (domestic[5] or foreign) holding shares in a CFC if the domestic corporation's indirect ownership of the CFC (applying the attribution rules of section 958) provides the domestic corporation the requisite 10 percent voting power.

A USSH may elect section 965 relief for a single tax year, either (i) its last tax year beginning before the date of enactment of HR 4520 or (ii) its first tax year beginning during the one-year period beginning on that enactment date. Section 965(f). For a calendar-year taxpayer, the choice is between 2004 and 2005. The effect on the "profit and loss" for financial statement purposes may be important, because the U.S. tax on the nondeductible portion will be a charge regarding amounts deemed permanently reinvested offshore (but will be an income item regarding amounts not deemed permanently reinvested offshore). From a U.S. tax standpoint, the advantage of continued deferral may tend to motivate taxpayers to wait. Further, the facts, for example, that the DRIP must be approved by company management before payment of the dividend, the lack of current guidance on various issues, and possible difficulties in funding the dividend, may also cause taxpayers to opt for the latter year. Foreign withholding tax developments also will be a key consideration and, as in the case of the U.S.-Netherland income tax treaty, incline taxpayers towards the latter year.

Section 965(f) provides that the election must be made not later than the due date, including extensions, for the federal income tax return for the year of the election. The conference report clarifies that the election is to be made on the return.[6]

III. Cash Distribution From CFC

A. General

Only cash distributions taxable as dividends for federal tax purposes, and amounts excluded under section 959(a) because included as subpart F income and attributable to same-year up-the-chain CFC- to-CFC distributions, are eligible for relief under section 965. In situations in which a foreign dividend withholding tax otherwise would be imposed, a taxpayer may determine to repatriate the funds by way of a redemption taxable as a dividend under section 302(d) or by way of a sale of CFC shares to another CFC taxable as a dividend under section 304. Those transactions would be considered to qualify.

Excluded are amounts treated as dividends under sections 78, 367 (subject to an exception described below), and 1248. Section 965(c)(3). Amounts includible as dividends under those sections generally do not correspond to cash amounts repatriated from a CFC. For example, while a section 1248 inclusion resulting from a USSH's sale of shares in a CFC does mean the USSH has received cash taxed as a dividend by reason of the CFCs earnings, the cash originates from the buyer and not from the CFC. Accordingly, depending on the facts, a presale distribution from the target CFC during the year of a section 965 election could be advantageous. By way of exception to the general rule, amounts included as dividend income by a USSH under section 367(b) by reason of an actual (not check the box)[7] inbound section 332 liquidation are potentially eligible for section 965 relief, but only to the extent of cash distributed. Section 965(c)(3). In the context of this form of section 367(b) dividend pickup, the cash actually moves onshore, similarly to an actual dividend.

Lobbying efforts to include, in particular, section 951(a)(1)(B) inclusions of amounts invested in "United States property" as defined in section 956 were unsuccessful, presumably because in many cases there would be no correlation between an "investment" as defined under that provision and the availability of cash funds targeted by the legislators.[8] In addition, except to the extent described in section III.B below, subpart F inclusions, even if accompanied by actual distribution of the income included (previously taxed income or PTI), are not eligible (which makes sense, as those repatriations are not incremental to the taxpayer's normal *modus operandi*).

Dividends of noncash property, even though actually distributed, do not qualify. Attempts in the legislative process to provide, for example, that distributions of promissory notes of a CFC would qualify were not

successful. The cash dividend requirement raises the question of what is "cash." It seems reasonable that cash equivalents, such as demand deposits and short-term time deposits, should be treated as cash for this purpose, and a variety of precedent can be cited. As a practical matter, in many cases the largest part of the distribution will derive from newly borrowed funds, and so there will be no issue. In other cases, there generally would be time to break time deposits but, given the amounts involved, it may be financially advantageous to assign the deposits.

B. Distributions From Tiered CFCs

Because of the fact that subpart F inclusions preempt actual distributions under the subpart F ordering rules, a special rule was needed to accommodate distributions from a CFC (lower-tier CFC) held in a chain of ownership described in section 958(a) by another CFC. Under sections 951 and 959, if a lower-tier CFC distributes an [P. 968] amount taxable as a dividend to another CFC and that amount is not excluded from subpart F income by reason of, in particular, the "same country" exception (section 954(c)(3)), the amount is currently includable by the USSH under section 951(a)(1)(A) for the tax year and any distribution of the amount, even in the same tax year, is excluded PTI under section 959(a). That amount is not treated as a dividend when distributed. Section 959(d). Section 965(a)(2) is designed to treat dividends from lower-tier CFCs as potentially eligible for relief by treating a cash distribution of PTI from a first-tier CFC as a cash dividend to the extent the USSH included subpart F income under section 951(a)(1)(A) as a result of either (i) a cash dividend received by that CFC from a lower-tier CFC, or (ii) a cash dividend received by a lower-tier CFC from another lower-tier CFC that is distributed up the chain to the first- tier CFC.

In effect, earnings distributed from lower-tier CFCs are potentially eligible for section 965 relief as long as the amounts are distributed in cash up the chain to the USSH.

C. Reduction for Increase in Related-Party Debt

The amount of the dividends qualifying for relief under section 965(a) must be reduced by any excess of the aggregate amount of indebtedness of the CFCs for which the taxpayer is a USSH that is owed to any "related" person (other than another such CFC) as of the close of the election year over the aggregate amount of indebtedness owed by those CFCs to any related person (other than another such CFC) as of the close of October 3, 2004.[9] Section 965(b)(3). Inter-CFC indebtedness is disregarded as a result of a provision treating all those CFCs as a single CFC for that purpose. See *id.* A "related" person for that purpose is as defined in section 954(d)(3) (in general, a person that by ownership of shares representing more than 50 percent by vote or value controls, is controlled by or is under common control with the CFC, with similar concepts for noncorporate entities).

That provision is, of course, intended to prevent the USSH or its non-CFC affiliates from funding the cash needed to make the dividend intended to qualify under section 965. As noted in the conference report, such an arrangement would not result in a net repatriation of funds. For that purpose, borrowings generally are treated as fungible and tracing is not allowed, with the result that any increase in related-party indebtedness is taken into account.

No exception is provided for some types of financing engaged in by commodities and securities dealers, such as sale and repurchase agreements (repos), securities loans, and other transactions in which deposits are made or received as collateral or margin.[10] Given the fact that those "loans" in effect represent no net borrowing, relief (which might have to take the form of a technical correction) would be appropriate.

Other exceptions, (for example, for account receivables) as well as antiabuse rules may be appropriate. The Treasury regulations dealing with "excess related group indebtedness"[11] may be useful by analogy. For example, a rule recharacterizing the equity capitalization of a financing CFC that makes loans to other CFCs as related-party indebtedness for this purpose may be appropriate.[12]

The provision does not cover USSH-guaranteed indebtedness. To the extent that indebtedness may be vulnerable, it presumably would be only under common law recharacterization as discussed in part III.D below.

D. Funding Issues

The requirement that the dividend be paid in cash by the CFC from which the earnings are to be repatriated, and continue up the chain to the USSH, can create funding issues for taxpayers. In many cases, the cash corresponding to unrepatriated earnings has been used to make acquisitions, purchase business assets, or pay down debt of the CFC. As noted above, loans from the U.S. group are not viable, as an increase in related-party indebtedness would result. In some cases, it is possible that sufficient liquid funds lie within the CFC group and can be lent to the appropriate distributing CFC. In most cases, however, other measures will be needed.

The result is a bonanza for bankers of every stripe. In many cases, it will be necessary for CFCs to arrange loans from or enter into leases with third parties. In some cases, a planned divestiture by a CFC may occur at an appropriate juncture so as to permit access to those funds. A CFC's sale of shares in another CFC, or another asset, to a direct or indirect parent USSH with the intention of later paying a qualifying dividend runs the risk that the transaction is treated as a noneligible distribution-in-kind (even assuming the purchaser is a different entity than the distributee). An equity infusion by the USSH with the intention of later paying a qualifying dividend incurs the risk that the dividend may not be given effect,[13] even assuming the infusion is made to one CFC that, for example, lends the funds to the distributing CFC.

For a third-party loan to a CFC, it generally would be economically advantageous to have the U.S. parent company of the group guarantee the loan. Subject to the "true borrower" question discussed below, such a guarantee generally should be acceptable under the statute as drafted (and any consistency between sections 163(j) and 956, on one hand, and section 965 on the other can be explained by the difference in purpose and context). If, however, the use of the funds is to retire USSH debt to promote financial stability, the presence of a parent guarantee may raise some question about that purpose.[14] [P. 969]However, there always would be a cash flow benefit to the USSH as distinguished from its CFCs, which may promote financial stability.

In some cases, the amount of loan needed to accommodate the amount desired to be repatriated may stretch the borrowing power of the CFC in question. Guarantees by other CFCs may help and would not be a section 965 problem, though a guarantee fee may be appropriate as a matter of arm's length dealing, including under the local law. A guarantee by the USSH may be necessary or desirable, at a minimum to achieve favorable financing terms. In cases of USSH guarantees, absent ameliorative guidance from the IRS, care must be taken to minimize exposure to an IRS assertion that the USSH, rather than the CFC or CFCs, is the true borrower.[15] It may be anticipated that, in view of the purpose of the statute to encourage repatriation of cash for permitted purposes and the normalcy of a parent guarantee, a lower level of scrutiny or sanction will be applied (for example, perhaps only loss of benefit if and when the guarantor is called on to make a payment).

An interesting issue is how quickly a third-party loan could be replaced with a loan from a USSH. Because the final date for measuring whether an increase in related-party indebtedness under section 965(b)(3) has occurred is expressly stated to be the last day of the election year, that provision would impose no limitation thereafter. Further, the other provisions of section 965 do not impose any durational limitations and take a broad (macro) tracing approach. Technically, a dividend out of funds borrowed from a third party could be paid on the last day of the election year and replaced with a USSH loan from other funds on the first day of the next year. Still, a modest waiting period may be advisable to avoid a "transitory" issue.

IV. Limitation to $500 Million/APB 23 Amount

The amount of otherwise eligible dividends, after reduction for excess related-party indebtedness, is subject to two additional limitations. The first generally is based on the amount of earnings permanently reinvested abroad, though a $500 million floor without regard to this standard is permitted.

A. Operation and Purpose of Limitation

The amount of qualifying dividends may not exceed the greater of $500 million or the amount "shown" on the "applicable financial statement" regarding the USSH as "earnings permanently reinvested outside the United States." Section 965(b)(1). The latter amount derives from Accounting Principles Board Opinion 23 (APB 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 the liability meets a specified criterion for "indefinite" deferral[16] and should be construed consistently therewith. 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 amount of the section 965(b)(1) limitation on the qualifying dividend is the floor limitation amount, $500 million.

The "applicable financial statement" of a USSH refers to the most recently audited financial statement (including notes and accompanying documents) that included the USSH and that is certified on or before June 30, 2003, as being prepared in accordance with generally accepted accounting principles and used for purposes of reporting to creditors or shareholders or for "any other substantial nontax purpose." Section 965(c)(1). For a corporation required to file a financial statement with the Securities and Exchange Commission, "applicable financial statement" means the most recent financial statement filed with the SEC on or before June 30, 2003.

The purpose of the limitation based on the APB 23 amount is to limit the relief to amounts that are identifiable as amounts that are unlikely to be repatriated in the absence of legislation. The 2003 date results from the long gestation period of the legislation. Lobbying efforts to roll the period forward to June 30, 2004, were unsuccessful, principally because of concerns that the APB 23 amounts for financial statements certified or filed after June 30, 2003, might have been first established or artificially inflated by taxpayers seeking an increased benefit, and because the bill's revenue cost would have increased.

The $500 million floor can be rationalized as an acknowledgement that some companies (especially privately held companies) may not have designated earnings as permanently invested outside of the United States (or not have reflected such designation adequately on their financial statements) even though they would be unlikely (in the absence of an incentive like the legislation) to repatriate them. The $500 million floor was not included in the House bill as introduced in July 2003.[17]

When 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. That, however, is erroneous, because 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 includes **[P. 970]** only the incremental U.S. tax liability. Accordingly, dividing by 0.35 substantially understates the corresponding income. This drafting error was quickly discovered and made the subject of a colloquy involving Sens. Charles E. Grassley, R-Iowa, and Rick Santorum, R-Pa.[18] In response to Santorum's colloquy, 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." *Id.* Accordingly, before dividing by 0.35, taxpayers should be permitted to increase the amount of U.S. tax liability shown in the statements by the amount of U.S. foreign tax credit reflected in that U.S. tax liability.

B. Allocating Limitation Among Multiple USSHs

When more than one USSH has a claim to the limitation amount, the limitation amount must be divided among them. First, all corporations treated as a single employer under section 52(a) (which provides grouping rules for purposes of the "work opportunity credit") are limited to a single $500 million limitation amount, which is to be divided among those corporations under regulations to be promulgated. Section 965(c)(5)(B).

Similarly, if more than one (corporate) USSH share the same applicable financial statement, then the APB 23 amount shown thereon must be divided among the USSHs under regulations to be promulgated. Section 965(c)(5)(C). In the case of an affiliated group filing a consolidated federal income tax return, all member USSHs are "treated as one [USSH]." Section 965(c)(5)(A). Multiple USSHs on an applicable financial statement, however, can exist if domestic corporations under common ownership and owning (or deemed under 958 to own) a 10-percent-or-greater voting interest in one or more CFCs are not included in a consolidated return. Further, if, for example, a domestic corporation owning a CFC for which there is an eligible APB 23 amount is sold or spun off by an affiliated group filing a consolidated return before or during an election year, there would be two

USSHs for that APB 23 amount. That also would be the case if the purchaser itself were an affiliated group filing a consolidated return; in that case, per section 965(e)(5)(A), the target USSH would be treated as part of a single USSH consisting of the purchasing group.

When an acquisition or spinoff is involved, it seems reasonable to apply rules analogous to those applicable to the determination of the base period under those circumstances, as contained in section 965(b)(2)(C), discussed below in part V.B. In cases not involving acquisitions or spinoffs, it seems reasonable that the regulations permit taxpayers to agree among themselves in a written agreement filed with the IRS as to how they wish to divide the limitation amount. If they do not do so, an appropriate general rule for the APB 23 amount may be to first allocate it among the relevant CFCs that generated the earnings in question and then allocate those respective earnings to USSHs in the same proportion as they would include income under section 951(a)(1)(A) from the respective CFCs.[19] In the absence of an agreement among the USSHs to the contrary, an appropriate general rule regarding the $500 million limitation may be to first allocate it to the relevant CFCs in proportion to their respective accumulated earnings and profits accounts as of the last tax year ending on or before June 30, 2003, and then allocate those respective amounts among the USSHs in the same proportion as they would include income from the respective CFCs under section 951(a)(1)(A).

Apart from the foregoing, the statute does not require or permit the eligible APB 23 amount to be adjusted to reflect changes subsequent to the date of determination, even changes resulting from extraordinary transactions directly involving a CFC. For example, if earnings from a CFC that were included in the APB 23 amount were distributed to the USSH in, for example, October 2003, the eligible APB 23 amount for purposes of section 965 is unaffected. Similarly, if shares in a CFC the earnings of which were included in the eligible APB 23 amount were sold in October 2003 and the proceeds were received by or distributed to the USSH, the relevant APB 23 limitation of the selling USSH under section 965 is unaffected. In the same vein, if shares in a CFC the earnings of which were included in the eligible APB 23 amount of a selling USSH were purchased in October 2003 by a new USSH, the purchasing USSH's eligible APB 23 amount is not increased.

V. Limitation to Extraordinary Dividends

A. Operation and Purpose of Limitation

A further limitation on the amount of the dividends eligible for relief, which derives from the fact that section 965 was intended to promote extraordinary dividends, seeks to limit relief to incremental amounts of dividends above an historical average. Specifically, section 965(b)(2) provides that the amount of eligible dividends is limited to the *excess* (if any) of the aggregate (qualifying and nonqualifying) dividends received by a USSH from all CFCs during the election year *over* the annual average for the base period years of the sum of:

> (i) the aggregate (qualifying and nonqualifying) dividends received by the USSH from all CFCs during each of the base period years;
>
> (ii) the amounts includable by the USSH in gross income for each base period year under section 951(a)(1)(B) (relating to investments in U.S. property) with respect to all CFCs; and
>
> (iii) the amounts that would have been included in income by the USSH for each base period year with respect to all CFCs as subject F income under section 951(a)(1)(A), or by reason of an investment in United States property under section 951(a)(1)(B), but for section 959(a).

[P. 971]

To avoid double counting, the amount taken into account in the base a period amount under clause (iii) (distributions excludable from gross income under section 959(a)) does not include an amount that is excludable from gross income by reason of an amount includable in the base period amount for a prior tax year under clause (ii) (reflecting income inclusions resulting from an investment in U.S. property).

There are some inconsistencies in the amounts that may be counted toward the minuend as opposed to the subtrahend in the formula above. The minuend includes only dividends (including deemed dividends under section 965(a)(2)). The subtrahend (base period amount, consisting of clauses (i) through (iii)) also includes, first,

income inclusions resulting from investments in U.S. property even though those inclusions are not permitted to be included in the minuend or in the section 965(a)(1) amount of dividends eligible for relief. The exclusion from the section 965(a)(1) amount is understandable, as noted above, because many types of section 956 investments would not further the purposes of the statute. The inclusion in the base period amount presumably is intended to reflect the prevalence of affirmative section 956 inclusions and the notion that, because the taxpayer was willing to have an income inclusion for those amounts, those amounts should not be considered new repatriations. The second item that is inconsistent is that section 959(a) distributions of subpart F income other than "up the chain" dividends are not included in the minuend, but section 959(a) distributions of all subpart F income are included in the subtrahend. The narrower scope of eligible subpart F income under section 965(a) makes sense in terms of the statute's purpose to encourage actual incremental dividends, but it is not clear why section 959(a) distributions corresponding to other subpart F income must be included in the base period amount, even acknowledging they represent actual cash distributions.

In general, the base period years are the three tax years that are among the five most recent tax years ending on or before June 30, 2003, determined by disregarding the tax year for which the sum of the amounts in clauses (i), (ii), and (iii) are the smallest as well as the tax year for which the sum is the largest. Section 965(c)(2). If, however, the taxpayer has fewer than five tax years ending on or before June 30, 2003, then the base period years include all the taxpayer's tax years ending on or before June 30, 2003. *Id.* Thus, the base period could consist of between one and four years, depending on the period of the taxpayer's existence. The choice of June 30, 2003, is consistent with the end date chosen for the applicable financial statement, as discussed above, and again reflects the fact that draft legislation incorporating those concepts had been released and a concern that taxpayers might take tax- motivated actions to optimize results under the legislation.

The base period amounts are determined on the basis of amounts as shown on the USSH's federal income tax return filed for the relevant base period year. 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. Section 965(b)(2).[20] Interestingly, even though the tax period in question would have previously ended, and an amended tax return generally could only reflect events occurring during the tax period, there was a concern that an amended return could be a means to adopt an inappropriate position (perhaps to reverse an affirmative inclusion under section 951(a)(1)(B)). The June 30, 2003, restriction on amended returns also is to some extent inconsistent with the fact that the final return for a June 30, 2003 USSH would not be due until March 15, 2004. More significant as a practical matter is that the taxpayer's reporting position governs. The amounts apparently need not necessarily be *properly* "shown" on the return,[21] and adjustments as a result of examination apparently are not taken into account.

B. Extraordinary Transactions

Section 965(b)(2)(C) sets forth rules addressing the effect of some extraordinary transactions, such as acquisitions, dispositions, and spinoffs, on the base period amount. Relevant transactions would be those occurring from the beginning of the base period through the end of the election year under section 965. For acquisitions and dispositions (including by merger), rules "similar to" the rules of section 41(f)(3)(A) and (B) (dealing with the effect of acquisitions and dispositions on the computation of the base amount for the credit for research activities by members) are intended to apply. Section 965(b)(2)(C)(i).

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 tax year ending after the acquisition, the amount of the acquiror'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. 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 by a like amount, but only if the disposition occurs in a transaction to which section 41(f)(3)(A) applies and if the disposing party furnishes the acquiror with the information necessary to apply section 41(f)(3)(A).

For purposes of section 41(f)(3)(A), an "acquisition" includes an incorporation or liquidation, and 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. [P. 972] sections 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. Treas. reg. section 1.52-2(b)(1)(ii). A "separate unit" is a segment of a trade or business capable of operating on its own with minor adjustments. Treas. reg. section 1.52-2(b)(2)(i). The determination of "the major portion" of assets takes into account relative fair market values, goodwill, number of employees, and sales and income of the transferred business as compared with the remaining assets. Treas. reg. section 1.52-2(b)(3).

As noted, "similar" rules are to apply for purposes of the section 965(b)(2) base period amount. This approach may be too facile for a problem that is really quite complex. For one thing, section 41 addresses levels of investment (in research and development), whereas section 965 addresses levels of disinvestment (distributions). While the purchaser of a business with historical R&D levels may be expected to maintain a similar level of investment in R&D and the seller to not, a similar expectation cannot be said to exist for likelihood or capacity to make distributions. For example, if CFC A owned by USSH X sells assets (received by it pursuant to a presale "check the box" election) to CFC B owned by unrelated USSH Y for cash, CFC B may well have had to borrow to purchase the assets and be in no position to add yet more leverage to pay a dividend, particularly one in excess of an "inherited" base period amount. Conversely, CFC A having received the sale proceeds, may be in a very good position to pay a dividend, particularly if freed from the corresponding base period amount. In the unlikely case that the acquisition were for shares the situation would not be as clear, but rather would depend on, for example, whether CFC A held back cash or levered the entity and whether the shares could be monetized. If USSH X sells the shares of CFC A to CFC B, again, CFC B may be in no position to pay a dividend. In this case, however, a CFC owned by USSH X may not be either, since USSH X would have sold the shares of CFC A. Layered on top of this is the fact that the APB 23 amounts of USSH X and USSH Y, respectively, apparently would not be affected by the transaction.

In any event, if rules similar to those under section 41(A)(3) are applied, the rules might be applied regarding transfers of a trade or business (including interests in an entity holding a trade or business) in the following manner. If an entire trade or business is acquired, preacquisition distributions or inclusions by a predecessor USSH that can be traced to that trade or business should be added to the base period amount of the acquiror in their entirety (and removed from the base period amount of the disposing party). If less than all, but the "major portion," is acquired, an allocable or ratable portion should be included in the acquiror's base period amount (and removed from the disposing party's base period amount). In such a case, some measure for attribution of prior dividends, etc. to that trade or business is needed. In many cases in which a partial interest in a single trade or business would be acquired, the arrangement will be a joint venture, and the percentage interests (by value) in that joint venture could serve as the basis for apportionment. Even when that is not the case, an allocation based on relative values generally should be feasible.

Special rules also apply to section 355 distributions during the base period if the controlled (distributed) company is a USSH. In that case, (i) the controlled corporation is treated as being in existence during the period that the distributing corporation is in existence, and hence would have the same base period as the distributing corporation (even if the controlled corporation is newly formed). Provided that either the distributing corporation or the controlled corporation is a USSH of a CFC, for purposes of determining the base period amount, amounts potentially includable in a base period amount (that is, described in section 965(b)(2)(B)) received or includable by either the distributing corporation or the controlled corporation before the section 355 distribution are to be allocated between those corporations "in proportion to their respective interests as United States shareholders of such [CFC] immediately after such distribution." Section 965(b)(2)(C)(ii)(II). Such apportionment based on post-transaction ownership seems to be a reasonable approach, aligned with the ability to repatriate funds from the CFC.

VI. Reinvestment Plan (DRIP)

A. General

To qualify for relief under section 965(a), "the amount of the dividend" must be "invested in the United States pursuant to a domestic reinvestment plan." Section 965(b)(4).[22] Failure to so invest any portion of that amount

may taint the entire dividend (although the harshness of such a rule suggests that, in cases of reasonable cause or good faith, an ability to "cleanse" the shortfall through a subsequent qualifying investment should be permitted).[23] On the other hand, section 965(d)(3) and the conference report make clear that separate dividends are viewed independently for purposes of this requirement. Accordingly, separate dividends for some purposes may be advantageous to minimize risk of complete disallowance for a partial taint. Further, pending Treasury/IRS clarification on that point, separate bank accounts to facilitate the tracing of the use of the funds and forestall any "co-mingling" argument may be advised.

The DRIP must provide for "the reinvestment of such dividend in the United States (other than as payment for executive compensation), including as a source for the funding of worker hiring and training, infrastructure, research and development, capital investments, or the financial stabilization of the corporation for the purposes of job retention or creation." Section 965(b)(4)(B). The conference report confirms that the recited list of permissible uses is not intended to be exclusive.[24] Thus, the only absolute limitation is that the funds be "invested in the United States." The Joint Committee on Taxation report, [P. 973]but notably not the conference report, states that the provision is to be "construed broadly."[25]

The issue of permitted uses has been the subject of extensive lobbying, as is evident from the statutory language. The resulting test remains the subject of uncertainty and speculation. Uses being considered for repatriated amounts may surprise at least some in Congress. For example, as reported in *The Wall Street Journal*, companies are considering using the funds to fund dividend increases and buy back shares (as well as repay debt and make acquisitions).[26]

B. Tracing

A threshold observation in respect of the DRIP requirement is the premise underlying section 965(b)(3), namely, that focusing on the use of particular funds, rather than on any net change (in percentage or absolute terms) in overall funds invested in the United States as compared with abroad, is an appropriate way to effect the congressional intent of increased domestic investments to promote domestic job growth. That is a curious premise when viewed in economic terms, but perhaps can be explained by the administrative complexity of the alternatives. It also is curious in light of the recognition in other provisions addressing the use of funds that operate on the principle that cash is fungible. See, for example, section 864(e); Treas. reg. section 1.861-9T; Treas. reg. section 1- 882-5. But see Treas. reg. section 1.163-8. There does not appear to be anything (even acknowledging a general inconsistency with the purpose of the statute) to prevent a taxpayer from using the funds to pay a large tort liability while borrowing funds or even using cash on hand to invest by way of equity contributions abroad[27] (although other considerations may make that unattractive). Similarly, it apparently would not make a difference if cash needs of the USSH were created as the result of, for example, a prior but separate dividend paid by it as part of an overall plan.

The rules regarding related-party indebtedness, discussed in part III.C above, which do test for a change in overall position, are an exception to this macro tracing concept. Those rules, however, are confined in scope to the amount of indebtedness owed by CFCs to their USSH(s).

A second question under the rubric of tracing is to what extent particular funds must be followed through the financial system and corporate accounts to the ultimate investment. On one hand, the taxpayer enjoys the benefit of macro tracing, as noted above, which at least suggests that a micro tracing of the funds through the system might be required. That the DRIP plan must provide for reinvestment "of such dividend" and not "an amount equal to the dividend" also suggests tracing of funds. On the other hand, no real purpose of the legislation would seem served by requiring a strict tracing of funds. In the author's view, Treasury/IRS should provide guidance that the funds used for the investment(s) described in the DRIP need not be directly sourced to those distributed by the CFC(s) as long as an equivalent amount is properly invested pursuant to an overall plan. As noted above, however, pending further guidance, separate bank accounts may be advisable to facilitate tracing of the funds if necessary.

C. Permitted Uses

The description of permitted uses in the statute needs to be articulated in greater specificity by Treasury and the IRS. Ultimately, in view of the stakes, taxpayers are likely to hew closely to the positions so articulated. Below, however, are a few initial observations on some types of uses for repatriated funds.

1. Interim investment. Investing the funds in short-term deposits or securities, pending the time when the funds are needed for the designated use, should clearly be acceptable. At least if micro tracing will not be required (see discussion above), a taxpayer also should be permitted to use the funds, for example, to repurchase, the taxpayer's commercial paper pending the targeted investment (even if such a reduction in short-term liabilities does not qualify in its own right as a qualifying investment).[28]

2. Payment of tort or tax liabilities or contractual indemnity obligations. Again, such a use should clearly be acceptable (unless, perhaps, the indemnity obligations relate to a foreign acquisition or venture).

3. Payment of trade liabilities, wages, or ordinary operating expenses. Such a use should be acceptable inasmuch as the funds are being devoted to the direct cash needs of the business. It is possible to take the view, however, that, perhaps as in the case of payment of short-term indebtedness (see below), there is less clearly an "investment" in the business. A distinction, however, should be drawn between the devotion of funds to the business (which is the "investment") and the use to which the funds so devoted are put within the business. Further, the fact that payment of executive compensation is expressly not allowed strongly suggests that payment of wages or other nonexecutive compensation is a permitted use.

4. Reduction of indebtedness. Indebtedness poses particular problems because of the fungibility of borrowings, the fact that in many cases it can be incurred at will, coupled with the fact that a new indebtedness in effect reverses a reduction of indebtedness. The statute refers to "financial stabilization of the corporation for the purposes of job retention or creation." "Corporation" for that purpose should refer to the USSH as opposed to the CFCs. Recognizing that the listed purposes are not exclusive, and that a reduction of debt *will* produce substantial cash flow savings for the USSH (as opposed to the [P. 974]CFC(s)), it is not clear what, if anything, further is required for a reduction of debt to qualify under this language. For example, in the case of an AA rated institution, does retirement of debt do anything for job creation or retention? Should there be a distinction between short-term as opposed to mid-term or long-term debt? If funds are used to reduce debt, should the change in the leverage of the taxpayer be required to be of some duration (absent an unforeseeable change in circumstances)? If not, or even if so, should reborrowings within a specified period thereafter be required to be applied to a permitted purpose? Does the purpose for which the debt was originally incurred matter (for example, suppose the debt was incurred four months earlier and its proceeds used for a nonqualified purpose)? If the debt is convertible or otherwise equity-linked, the repurchase may be closer to a stock repurchase (discussed below).[29]

5. Acquisition of a business entity or integrated business operation with primarily (by value) domestic operations. Such a use should clearly be acceptable. The fact that acquisitions often lead to loss of jobs, while ironic given the purpose of section 965, should not change that conclusion. Even though a minority of the operations may be foreign, bifurcation is not necessarily appropriate. No distinction should be drawn between asset purchases of pass-through entities and purchases of shares of a corporation, provided that if a business entity (including a disregarded entity or a purchase via a section 338(h)(10) election) is not purchased, the operations are integrated. Antistuffing rules could be appropriate.

6. Acquisition of a business entity or integrated business operation with primarily foreign operations. The general test of the statute is that the funds be invested "in the United States." An acquisition of primarily foreign operations does not meet that standard except to such extent, if any, as a bifurcated approach may be adopted (see below).

7. Repurchase of shares.[30] A repurchase of shares represents an outflow of funds and a shrinking of the enterprise. Thus, generally, in this case, it is the shareholders who are investing. Not only is there no way to know how they will do so, but inevitably there will be foreign shareholders likely to invest outside of the United States. Under some circumstances, however, a share repurchase might be viewed as increasing the financial stability of the enterprise. For example, a redemption of preferred stock could be considered an elimination of a tranche of financing that no longer comports with the financial posture of the business. A second example could be shares

are held by a dissident shareholder when the dissension rises to the level of creating financial instability. A third could be to forestall a takeover threat, or possibly even if common shares are trading at unusually depressed prices relative to perceived value as a result of something other than general market conditions, and there otherwise is reason to fear a takeover. The issue for Treasury/IRS in deciding to open the door in this regard is that for every case that may actually be justified as potentially protecting or creating jobs, there likely could be many more for which the justification is reed-thin.

8. Funding dividends or increased level of dividends. This raises concerns similar to those described above for a repurchase of shares. Under some narrow circumstances, however, a payment of dividends might be viewed as contributing to the financial stability of the enterprise. For example, if cumulative preferred stock dividends are in arrears, a payment of those dividends might be viewed as increasing financial stability.

In deciding what uses are permitted, one may conclude that the language is broad and ambiguous enough to be read so as to permit virtually any use that does not leave a trail of funds going abroad.[31] However, it is clear from the legislative history that Congress expected the uses of the funds to further job growth or preservation in the United States, and the ultimate standard under the statute is that the funds be "invested in the United States." That standard is grounded in an economic objective and expressed in economic terms, unlike, for example, the section 956 concept, of "investment in the United States property," which has a very different purpose. One, therefore, might speculate whether Treasury and the IRS might consider the view of government economists in making a determination for this purpose (unlikely).

The statute assumes that a use will be entirely qualifying or entirely not. That leaves the question whether, if a use cannot be characterized as wholly a U.S. investment or wholly not, the use should be bifurcated. If such an approach were taken, leaving aside the administrative complexity, it would require and permit taxpayers to treat only the qualifying portion as acquired with the qualifying dividend and the nonqualifying portion with other funds.

Another question is over what time frame must the funds be used for the permitted purpose. For example, would it be satisfactory to hold the funds in investment assets for 10 months (or 16 months) before using them for the designated purpose and, if so, under what condition? The statutory language ("as a source for the funding of") certainly contemplates establishing a cash fund or reserve. If there is a generally applicable outside limit, is it extended if factors that were not reasonably foreseeable cause the delay?

D. Specificity and Drafting

In terms of the formal requirement of a DRIP, there is the question of how specific the plan must be. At one extreme would be earmarking a specific amount for each intended use and identifying the intended use by specific [P. 975]reference (for example, payment of a specific liability, acquisition of particular assets, etc.). Even if that were required (and the author does not believe it should be), deviations in implementation reflecting, for example, the unavailability of those assets or a difference in the amount of liability required to be paid clearly should be acceptable. At the other extreme, a designated use no more specific than "domestic acquisitions" or "retirement of debt" may be acceptable. The fact that transactional uses, such as acquisitions, require negotiations with third parties, the outcome of which may be unpredictable, strongly suggests that flexibility in identification should be permitted.

A separate issue is whether the plan may set forth alternative permissible uses (for example, a specified amount will be used for project A or project B). Such a formulation seems fully consistent with the statutory purpose and should be permitted.

In any event, the DRIP should include a provision that, to the extent funds earmarked for and estimated as needed for a particular use exceed the amount actually needed, the excess will be used for one or more other qualifying uses. The DRIP should not be required to specifically describe those uses under those circumstances, nor should it even be required that they be of a similar nature, but rather it should be permissible for the DRIP to recite, for example, "such other uses permitted under section 965 as the chief executive officer shall determine in writing to be appropriate."

Prudent drafters also may consider including a provision that the plan is intended to be construed in conformity with section 965(b)(4) and such guidance as may be promulgated thereunder, and if necessary to so conform shall be deemed modified *ab initio*. IRS guidance on the foregoing points is urgently needed.

E. Approval Requirements

The DRIP must be approved by the taxpayer's president, chief executive officer, or corporate official before the payment of such dividend. Section 965(b)(4)(A). It is not clear why that strict timing was considered to be required, and in particular, to what extent and if so why the particular uses of the funds must be articulated in the plan by the time the dividend is paid. Presumably if a taxpayer has one officer who is a chief executive officer and another officer who is a president, it would be prudent in the absence of guidance to have the plan approved by the CEO, that is, by the highest ranking of the officers mentioned. For an affiliated group filing a consolidated return, the members of the group are treated as a single USSH. Although there typically would be more than one president and even CEO, it would be prudent to have the CEO of the parent company approve the plan.

The DRIP also must be "subsequently approved by the taxpayer's board of directors, management, committee, executive committee, or similar body." Section 965(b)(4)(A). That approval can occur after receipt of the dividend, apparently with no time limitation.

VII. Taxation Under Section 965

A. Specific Identification of Eligible Dividends

Sections 965(d)(3) provides that, "unless the taxpayer otherwise specifies" a portion of each dividend received or included in income under section 951(a)(1)(A) by a USSH is treated as deductible under Section 965(a) in the same ratio as the total amount allowed as a deduction under section 965(a) bears to the total dividends (qualifying, including under section 965(a)(2), and nonqualifying, including in-kind) received by the USSH during the election year. That language is intended to permit a taxpayer to specifically identify dividends to apply against the section 965(b)(2)(B) base period amount and treat as nonqualifying, and other dividends to treat as qualifying dividends.[32]

Accordingly, to the extent possible (as, for example, if there exist more than one directly held CFCs with different effective tax rates), taxpayers will designate dividends from high-taxed pools of earnings and profit as applied against the base period amount and dividends from low-taxed pools as eligible for the section 965(a) deduction. Other structuring, as well as repositioning of entities, to preserve separate pools may be advisable. Potentially extremely favorable to taxpayers, this right to designate was considered necessary to encourage taxpayers to take advantage of the provision.

B. Tax Consequences for Deductible Portion

1. No foreign tax credit. A credit for foreign taxes relating to the 85 percent deductible portion of the dividend is not allowed under section 901.[33] Section 965(d)(1). The credit may be used neither against U.S. tax for the nondeductible portion of the dividend or section 951(a)(1)(A) amount referred to in section 965(a)(2) nor against U.S. tax on other foreign-source income; hence, the attribute in effect ceases to exist.

A technical correction is needed regarding section 78. Under that section, for any year in which a taxpayer claims the foreign tax credit, any distribution from a CFC that carries with it foreign income taxes eligible for the deemed credit under section 902 results in an inclusion in income of an amount equal to such foreign taxes. A provision is needed to "turn off" section 78 for the nondeductible portion of section 965(a) dividends.

2. Expense allocation. No deduction is allowed for "expenses properly allocated and apportioned to the deductible portion" of the dividend or section 951(a)(1) amount referred to in section 965(a)(2). Section 965(d)(2). No authority is provided for legislative regulations, and hence guidance must be interpretive.

The conference report offers no guidance on the nature of the expenses contemplated or the extent of the disallowance. However, House Ways and Means Committee Chair William M. Thomas, R-Calif., has stated: "The

[P. 976] intent of the rule is to disallow only deductions for expenses that relate directly to generating the dividend income in question."[34] Further, in response to Sen. Gordon Smith's, R-Ore., question whether it would "be reasonable to say that properly allocable and apportioned expenses would not include general and administrative costs not directly related to generating the income being repatriated and such indirect expenses as research and development costs, interest, state and local income taxes, sales and marketing costs, depreciation, and amortization," Senate Finance Committee Chair Grassley replied: "Yes, your understanding is correct. I would add that directly related expenses would include, but is not [sic] limited to, stewardship costs and directly related legal and accounting fees."[35] Those statements are very helpful and are likely to be given great weight by the Treasury and IRS in drafting guidance. Strictly speaking, however, colloquies on the congressional floor (even involving the chairs of the taxwriting committees) are not necessarily as compelling as, for example, the conference committee report for purposes of statutory construction and their force can depend on various factors.[36] The narrow scope of the expense disallowance requires prompt confirmation from the IRS and Treasury, as the economics of repatriation could be affected.

If one were to step back from the colloquies, an initial question would be what effect a section 965 dividend should have on allocations of expenses under the section 1.861 regulations[37] for the election year for which the amount of foreign source gross income is relevant (for example, for allocation of residual research and experimental expenditures if the gross income method is chosen, per reg. section 1.861-17(d)).[38] Although the deductible portion of a section 965 dividend is included in *gross* income, it generally would seem inappropriate and produce distortive results to include it in gross income for purposes of those calculations.

Under the existing regulations, however, for the allocation and apportionment of deductions to income that is "exempt or excluded," the exempt or excluded income is taken into account only if the deductions are "definitely related" to the class or classes of gross income.[39] If instead the deductions are definitely related either to a class of gross income consisting of multiple groupings of income or to all gross income, exempt income is not taken into account. Treas. reg. section 1.861-8T(d)(2)(i). For that purpose, "exempt income" includes the portion of dividends that are deductible under sections 243 or 245. Treas. reg. section 1.861-8T(d)(e)(ii)(B).

Under those rules, R&D expense would be definitely related to dividend income from a CFC if the CFC benefited from the R&D. See Treas. reg. sections 1.861-17(a)(1), 1.861-17(h) Ex. 2. If those rules governed the deductible portion of section 965 dividends, R&D expense could have to be allocated to the exempt portion of the dividends. As indicated above, that seems inappropriate. More importantly, it would be inconsistent with Grassley's explicit exclusion of R&D costs, and might also be inconsistent with Thomas's statement that only directly related expenses should be taken into account.

Turning to interest expense, the rules governing the allocation and apportionment of interest expense between U.S. and foreign sources, which generally are based on asset values, appear to operate as expected in this context. For example, assume a USSH holds U.S. assets worth $100 and CFC shares worth $100 on the first day of the tax year. If a distribution of $50 is made by the CFC during the year, and nothing else has changed, the relative values of U.S. and foreign assets will be $150 and $50, respectively. The average of the beginning and ending values for the year produces a ratio of 125:75 to be used for apportioning interest expense between U.S. and foreign sources. A taxpayer that pays the dividend at the end of the year would have the same allocation ratio as if the dividend were paid at the beginning of the year, thus motivating end-of-year payments, but that results from the two-look nature of the apportionment and is not unique to section 965 distributions.

The question would remain how much, if any, of the interest expense that is allocated to foreign source income should be further allocated to the deductible portion of the section 965 dividend and be treated as nondeductible. One way to approach the subject would be to compare the disallowance of expenses in respect of other exempt income, such as under sections 265 and 246A. While other expenses may be implicated in particular situations, the most significant relevant expense would seem to be interest expense. Unlike with the provisions cited, however, the income in question is not by its nature exempt but only on an election of the taxpayer. Further, whether CFC shares generate exempt income and to what extent will depend on the relevant facts as well as the election. Also, the exemption applies only to amounts received or included during a single tax year. Further, after the taxpayer repatriates the amounts, the CFC shares no longer could be said to generate tax-exempt income. Considering those distinctions, it is not clear that meaningful expenses would be attributable to the deductible

portion of the dividend. One possible approach would be to apportion the USSH's interest expense allocable to non-U.S. sources for the portion of the [P. 977] election year preceding the USSH's receipt of the qualifying dividend between the amount of the deductible portion of the dividend and the value (fair market value or tax basis,[40] depending on the taxpayer's section 1.861-9T method) of the taxpayer's total foreign assets net of that dividend. It may be, however, that even that allocation would be inconsistent with the "directly" related concept articulated by Grassley and Thomas.

Regardless of whether a deduction for some interest expense would be so disallowed, there remains the question of for which other expenses may a deduction be disallowed as relating to the nondeductible portion of the dividend. As a practical matter, the amount of such other expenses should be small, especially in view of Grassley's and Thomas's statements that only "directly" related expenses are targeted. The only examples of *any* expenses that actually would be disallowed are "stewardship costs and directly related legal and accounting fees," referred to in Grassley's colloquy with Smith.[41]

3. Coordination with alternative income tax. A final aspect of the tax treatment of the nondeductible portion concerns the alternative minimum tax. To avoid having the deductible portion of a section 965 dividend contribute towards possible AMT liability, new section 56(g)(4)(C)(vi) is added to *exclude* a deduction for such portion from the normal rule offsetting deductions from alternative minimum taxable income if the deduction does not reduce earnings and profits. That exception is consistent with the treatment provided for some dividends eligible for a 100 percent or 80 percent dividends received deduction.

C. Tax Treatment of Nondeductible Portion

The 15 percent nondeductible potion of a section 965 dividend is intended to be fully includable subject to regular corporate income tax, thus resulting in an effective tax rate, before credits, of 5.25 percent. The statute provides that the taxable income of a USSH for any tax year "shall in no event be less than the amount of nondeductible CFC dividends received during such year." Section 965(e)(2)(A). "Nondeductible CFC dividends" is defined as the 15 percent nondeductible portion of qualifying section 965(a) dividends. Section 965(e)(3). Accordingly, that taxable income may not be reduced by dividends received deductions under sections 243 or 245 (section 965(c)(4))[42] or otherwise. The amount of net operating loss, if any, and taxable income for purposes of using a net operating loss are not affected by the nondeductible amounts. Section 965(e)(2)(B).

Although taxable income from nondeductible CFC dividends may not be reduced by deductions, the tax thereon may be reduced by foreign tax credits, both those associated with the nondeductible portion of the section 965(a) dividend (see section 965(e)(1)) and apparently excess credits that may otherwise be available to the taxpayer. One commenter has suggested that a taxpayer may go further and designate a part of a single dividend (the nondeductible portion) as being from high-taxed earnings and another part (the deductible portion) as being from low-taxed earnings.[43] It does not appear, that the identification of dividend concept provides a basis for the bifurcation of a single dividend, however, and the conference report refers to "proportional disallowance" of foreign tax credits, even in the context of an identification of dividends.[44]

The U.S. federal income tax imposed by reason of nondeductible CFC dividends is not treated as imposed for purposes of determining either the amount of any income tax credit (other than that under section 53 for prior year AMT and that under section 27(a) for foreign tax credits) or the amount of AMT under section 55. Section 965(e)(1).

D. Tax Consequence of Failure to Qualify

The tax consequence of an unintended failure to qualify a dividend under section 965 would be in many cases an unmitigated disaster. The dividend, which presumably would have been out of earnings pools selected on the basis of their low-taxed nature, would be fully taxable with little in the way of foreign credit relief (absent the existence of credit carryovers). Accordingly, there is a premium on relative certainty of being right, as well as on strategies to reduce risk (such as paying a separate dividend and segregating the funds in respect of any purpose that is less than clearly permitted).

VIII. Conclusion

Section 965 appears to be a provision that was driven more by tax politics than tax policy. Regardless of the circumstances of its birth, however, the provision and its legislative history state a fairly clear message that repatriation of cash is to be encouraged. Normal tax rules, such as substance over form and fungibility of money, apply, if at all, in only a limited fashion. Ultimately, the practical application of the rules will be dictated by positions adopted by the IRS and Treasury in the coming weeks and months.

FOOTNOTES

[1] Pub. L. No. 108-357, 118 Stat. 1418 (2004).

[2] American Jobs Creation Act of 2004 Conference Report, H.R. Rep. No. 108-755 (hereinafter, Conf. Rep.), at 65. Of course, one Congress cannot bind another (or even itself).

[3] For one view of the merits of the earnings repatriation provision, see J.Clifton Fleming and Robert J. Peroni, "Eviscerating the Foreign Tax Credit Limitations and Cutting the Repatriation Tax -- What's ETI Repeal Got to Do With It?" *Tax Notes,* Sept. 20, 2004, p. 1393 at 1406-1414. The administration itself was not supportive of the provision, in part on grounds of fairness (perceived favoritism towards offshore as compared with onshore earnings).

[4] An ironic consequence, however, is that a taxpayer that established an offshore finance company along the lines of that in Enron's Project Apache in theory could restructure as a CFC so as to qualify. "Excess distributions" from a passive foreign investmeny company, however, would not qualify. *See* section 1291.

[5] The definition of USSH would include but not be limited to a domestic partnership owner in the chain.

[6] Conf. Rep. at 65 n.107.

[7] As noted in the conference report, a mere "check the box" section does not result in the movement of cash. Conf. Rep. at 66 n.108.

[8] Qualification of those investments would have been beneficial even if limited to some "approved" categories, inasmuch as the "hopscotch" nature of the inclusion would have facilitated targeting particular earnings to apply towards the base amount and other earnings as qualifying.

[9] This date reflects the timing of the addition of this concept to the draft provision.

[10] *Compare* section 956(c)(2)(J), (K).

[11] Treas. reg. section 1.861-10(e).

[12] Treas. reg. section 1.861-10(e)(8)(v).

[13] *See, e.g.*, FSA 200135020, *Doc 2001- 22920 [**PDF**], 2001 TNT 171-14* [1](increase in contributed capital followed by purported dividend characterized as stock dividend, and associated foreign tax credit denied).

[14] As discussed in part VI.C below, the targeted financial stabilization of the corporation apparently must be for the purpose of job creation or retention. A relevant question may be what extent replacing a direct liability of the USSH with an unconditional guarantee either increases financial stability of the USSH or promotes jobs.

[15] *See, e.g., Plantation Patterns Inc. v. Comm'r*, 462 F.2d 712 (5th Cir. 1972), *cert. denied* 409 U.S. 1076.

[16] *See* Conf. Rep. at 67 n. 111. Obviously, there is some tension between the position that earnings are permanently reinvested outside of the United States and the fact that the taxpayer is considering whether to repatriate the earnings. The consensus view in the public accounting profession, however, appears to be that evaluation of the merits of taking advantage of section 965 relief does not by itself change the status of the earnings if a decision is made not to repatriate, in view of the unique aspects of the provisions and its temporary one-time nature.

[17] American Jobs Creation Act, H.R. 2896 (introduced July 21, 2003).

[18] 150 *Cong. Rec.* S11019, S11036 (Oct. 4, 2004).

[19] Using the respective annual average base period amounts determined under section 965(b)(2)(B) as a basis of apportionment to USSHs would not be appropriate, inasmuch as these historical measure of dividends paid and specified inclusions in the base period amount would have no bearing on, or even be counterindicative of, the USSH's share of the APB 23 amount.

[20] Query whether returns deemed amended on or before June 30, 2003, pursuant to Rev. Proc. 94-69, 1994-2 C.B. 804, *Doc 94-9385, 94 TNT 202-12* [2], dealing with disclosure for section 6662 purposes, may be taken into account.

[21] The same standard is used for the APB 23 amount, but in a very different context. The APB 23 amount, which is included in certified statements, is acknowledged to reflect the intentions and judgment of management, rather than an objectively determinable amount.

[22] While this phrase refers to reinvesting the "amount" of the dividend, the DRIP must provide for reinvestment of "such dividend."

[23] That, however, could require a technical correction.

[24] Conf. Rep. at 67.

[25] J. Comm. on Tax., Description of the Chairman's Mark for the Conference Committee on H.R. 4520, October 4, 2004, *Doc 2004-19594 [**PDF**], 2004 TNT 194-5* [3], at 134.

[26] G. Simpson and G. Zuckerman, "Tax Windfall May Not Boost Hiring Despite Claims," *The Wall Street Journal*, Oct. 13, 2004, A-1, A-12.
[27] That assumes, of course, that the dividend and contribution either would not involve the same CFC or would not be virtually simultaneous, such that a netting argument might be avoided.
[28] *See* discussion in paragraph 4 immediately below.
[29] If different rules are appropriate, precedent of a sort would be section 249.
[30] One commenter has stated that it is "highly likely" that stock repurchases are properly encompassed by section 965(b)(4). R. Willens, "American Jobs Creation Act Includes Eclectic Mix of Provisions Impacting Investors," *Daily Tax Report* (BNA), Oct. 14, 2004, S-1 at J-2.
[31] One can only believe that the recently deceased French theorist Derrida would have had a fairly easy time demonstrating with this particular passage the futility of attempting to convey a common meaning through language.
[32] Conf. Rep. at 67.
[33] To the extent taxes in lieu of income taxes are potentially creditable, section 903 treats them as taxes covered by section 901, and hence a credit for those taxes also is prohibited. Section 27(a) allows a credit only "to the extent provided in section 901"; section 901 is modified in this context by section 965(d)(1).
[34] 150 *Cong. Rec.* H8714 (Oct. 7, 2004).
[35] 150 *Cong. Rec.* S10976 (Oct. 7, 2004).
[36] *See* Treas. reg. section 1.6662-4(d)(3)(iii) (floor statements made before a bill's enactment by use of its managers are "authority" for section 6662 purposes); Banoff, "Dealing With the Authorities: Determining Valid Legal Authority in Addressing Clients, Rendering Opinions, Preparing Tax Returns and Avoiding Penalties," 66 *TAXES* 1072, 1081-82 (1988). In this case, Thomas's statement leaves ambiguities but Grassley's statement is very clear.
[37] Those regulations allocate and apportion deductions between stationary and residual categories (for example, between foreign-source gross income from business and U.S.-source gross income from business).
[38] Another example would be allocations under reg. section 1.861-14T.
[39] A deduction is "definitely related" to a class of gross income if "it is incurred as a result of, or incident to, an activity or in connection with property from which such class of gross income is derived." Treas. reg. section 1.861-8(b)(2).
[40] The tax basis of CFC shares is increased by the CFC's earnings and profits for this purpose. Treas. reg. section 1.861-12T(c)(2).
[41] 150 *Cong. Rec.* S10976 (Oct. 7, 2004).
[42] This provision makes clear that sections 243 and 245 have no application to a dividend described in section 965(a), thus eliminating the possibility of a taxpayer claiming a deduction under both section 965 and sections 243 or 245 for the deductible portion.
[43] Willens, note 30 *supra*.
[44] Conf. Rep. at 67.

Federal Tax Watch

Foreign dividend repatriation holiday available in 2005

When a United States taxpayer conducts global business through a foreign subsidiary, the earnings of the foreign subsidiary are generally free from U.S. taxes until the foreign subsidiary repatriates the earnings in the form of a dividend payment to its parent or the subsidiary is liquidated.

Congress believed that the tax on the repatriation of foreign earnings might be a disincentive to repatriate these earnings back to the U.S. parent. As a result, it granted a temporary one-year reduction of tax on repatriated dividends to stimulate the U.S. economy.

New Internal Revenue Code Section 965(a) grants an 85 percent dividends-received deduction to the U.S. shareholders of U.S.-controlled foreign corporations (CFCs). The deduction is available for extraordinary cash dividends from a CFC, provided the dividends are invested in accordance with a domestic reinvestment plan.

Here's how the dividends-received deduction works:

Cash distribution requirement. The deduction is available only for qualifying cash dividends received in the taxpayer's last tax year that began before Oct. 22, 2004. Or, at the election of the taxpayer, the deduction may apply to the tax year that begins between Oct. 22, 2004, and Oct. 21, 2005.

Debt-funded distributions. A deduction is not allowed when the U.S. shareholder and its non-CFC affiliates lend money to the CFC to fund its distribution to the U.S. shareholder.

Floor and ceiling on qualifying dividends. The amount of CFC cash dividends may not exceed the excess of cash and noncash dividends received by the taxpayer during the year from CFCs over a base-period amount.

Reinvestment plan. The domestic reinvestment plan generally must fund worker hiring and training, infrastructure, research and development, capital investments or the financial stabilization of the corporation to retain or create jobs. The plan must be approved by the taxpayer's president or similar officer before the payment of the CFC cash dividend and be subsequently approved by the taxpayer's board of directors (or similar group).

Foreign tax credit disallowance. A taxpayer is not entitled to a deemed-paid foreign tax credit, nor a direct foreign tax credit or deduction, for foreign withholding taxes imposed on the deductible portion of the CFC cash dividends.

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