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August 25, 2005

The Honorable Charles Grassley
Chairman
Committee on Finance
United States Senate
Washington, DC 20510

The Honorable Max Baucus
Ranking Member
Committee on Finance
United States Senate
Washington, DC 20510

Dear Chairman Grassley and Senator Baucus:

I am writing in response to your request for comments on the technical corrections legislation (S. 1447) you introduced on July 21, 2005. These comments relate to section 965 of the Internal Revenue Code, enacted as part of the American Jobs Creation Act of 2004, and certain S. 1447 technical corrections provisions relating to section 965. As discussed below, clarifications to section 965 may be necessary to allow foreign-owned U.S. companies to repatriate earnings in accordance with the policy intended by Congress in enacting this provision.

Section 965(b)(3) concerns

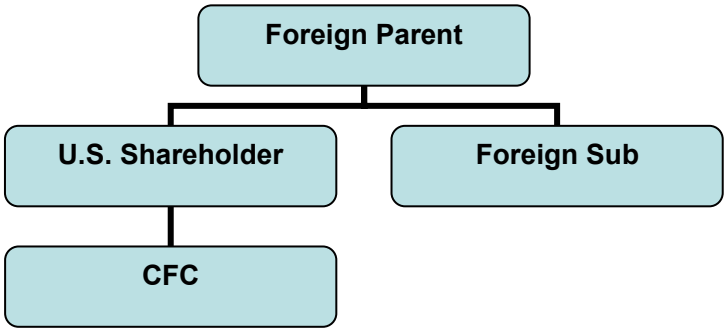
By way of background, section 965 generally allows an 85-percent dividends-received deduction for cash dividends received by a U.S. shareholder from a controlled foreign corporation ("CFC") in the U.S. shareholder's 2004 or 2005 taxable year.

Section 965(b)(3) sets forth a limitation based on a CFC's related-party indebtedness. Specifically, the amount of dividends eligible for the deduction is reduced by any increase in CFC indebtedness to related persons between October 3, 2004, and the close of the taxable year for which the deduction is being claimed. Section 965(b)(3)(A) defines a "related person" for this purpose by reference to section 954(d)(3), which defines a related person of a CFC broadly to include any entity that controls the CFC and any entity that is controlled by the same entity that controls the CFC. Section 965(b)(3) treats all CFCs of a U.S. taxpayer as a single corporation for purposes of the borrowing limitation.

The AJCA conference agreement explains that the section 965(b)(3) related-party borrowing limitation is intended to prevent a deduction from being claimed when a U.S. shareholder lends to a CFC in order to finance the payment by the CFC of the dividend. In that case, there would be no net increase in cash in the United States.

The section 965(b)(3) limitation on related-party indebtedness does not appear to have contemplated situations in which a foreign owned U.S. corporation

repatriates foreign earnings. While not the prototypical fact pattern, many foreign-owned U.S. companies own a CFC that may be in a position to bring earnings back to the United States. As is the case with CFCs of U.S.-owned multinational corporations, such a CFC may need to access funds in order to pay a dividend. Potential sources could include the foreign parent of the U.S. shareholder and foreign subsidiaries of the foreign parent itself.



As drafted, however, the section 965(b)(3) limitation will deny the CFC the ability to borrow from these non-CFC related foreign persons in order to fund the payment of a dividend that otherwise would qualify for the repatriation provision deduction. This result may have been inadvertent, since payment of a dividend funded by borrowing from a related foreign entity would indeed bring cash to the United States. Funds would move from the foreign entity to the CFC and then to the U.S. shareholder for investment in the United States. This movement of cash is fully consistent with the repatriation provision's intent. These additional potential sources of borrowing (i.e., the ultimate foreign parent and foreign subsidiaries of the foreign parent) available to foreign-owned U.S. companies do not exist for CFCs of U.S.-owned multinational corporations that may have been the prototype for drafters of the provision.

Concerns re: S. 1447

S. 1447 would expand on the 965(b)(3) related-party debt rule by providing Treasury with explicit regulatory authority to reduce the amount of eligible dividends in certain instances in which dividends are funded by cash transfers from a related party. Specifically, section 2(q)(3) of the bill provides:

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

The Joint Committee on Taxation ("JCT") summary (JCX-55-05) explains that this regulatory authority "supplements existing principles relating to the treatment of circular flows of cash." The JCT summary further states that this regulatory authority is to be exercised "only in cases in which the transfer is part of an arrangement undertaken with a principal purpose of avoiding the purposes of the related-party debt rule of Code section 965(b)(3)." The summary further discusses certain transfers (e.g., cash contributions for purposes of working capital) that would not be considered as having been undertaken to avoid section 965(b)(3).

The S. 1447 cash-transfer rule raises the same policy concerns as are raised by the underlying section 965(b)(3) limitation. That is, the amount of eligible dividends may be reduced when cash is transferred from a related foreign person to a CFC that pays an otherwise-eligible dividend to the U.S. shareholder. This is the result even though such transactions do not involve a circular cash flow (i.e., from the United States to the CFC and back to the United States) and will result in a net increase in cash for domestic investment which is fully consistent with the intent of Congress.

From a practical perspective, the S. 1447 cash-transfer rule is creating significant uncertainty in some situations. While the JCT's list of "good" cash transfers is helpful, it is not exhaustive. For example, there may be uncertainty when a CFC sells assets to a related foreign person for cash and pays an otherwise-eligible dividend to the U.S. shareholder.[1] While the taxpayer might argue that such a cash transfer was not made with the principal purpose of avoiding the section 965(b)(3) limitation, both the proposed statutory language and the JCT explanation are sufficiently broad to create uncertainty regarding the ultimate interpretation of this provision. The risk (i.e., the difference between a 35-percent tax rate and a 5.25-percent effective tax rate) would discourage payment of a dividend to the U.S. shareholder in this instance.

Solution

The solution to the concerns discussed above would be to amend section 965(b)(3) to clarify that funding via a loan or cash transfer from a CFC's ultimate foreign parent or a foreign subsidiary of the foreign parent does not disqualify otherwise-qualifying repatriation transactions from the benefits of section 965(a). This could be accomplished by a technical correction excluding foreign related persons from the definition of related persons for purposes of the section 965(b)(3) related-party borrowing limitation:

[1] I am aware of one proposed repatriation transaction viewed now (i.e., after introduction of S. 1447) with at least some uncertainty that involves a sale of CFC assets that is required by a foreign regulatory authority and whose planning began prior to enactment of section 965 – hardly the type of transaction that should be viewed as abusive in connection with a CFC's payment of a dividend to the United States.

SEC. ___. AMENDMENT RELATED TO THE AMERICAN JOBS CREATION ACT OF 2004.

(a) AMENDMENT RELATED TO SECTION 422 OF THE ACT—Section 965(b)(3)(A) of the Internal Revenue Code of 1986 is amended by striking '(as defined in section 954(d)(3))' and inserting in its place '(as defined in section 954(d)(3), except that related persons for this purpose shall not include any foreign persons)'.

Thus, the section 965(b)(3) limitation would disregard any borrowing by a CFC from its ultimate foreign parent or a foreign subsidiary of the foreign parent. This definition of "related persons" also would apply, by extension, for purposes of the S. 1447 cash-transfer rule, which "piggybacks" off of the section 965(b)(3)(A) definition.

To avoid any potential abuse from a circular flow of cash, the legislative history would provide that Congress expects Treasury would treat any back-to-back funding or cash transfer (e.g., a loan from a U.S. related party to a foreign related party coupled with a loan from the foreign related party to the CFC) as a direct cash transfer from a U.S. related party to the CFC for purposes of the related-party indebtedness rule.

A narrower solution, at least for some taxpayers contemplating repatriation transactions, would be to clarify that a cash transfer to a CFC as a result of the sale of assets by the CFC to a foreign related party or a transfer of cash by a foreign related party to repay a bona fide debt owed to a CFC would not be considered as having been undertaken primarily to avoid section 965(b)(3).

In either case, because repatriation transactions generally must be completed by the end of 2005, it would be necessary to communicate this clarification as quickly as possible if technical corrections legislation cannot be enacted in an expeditious manner.

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Thank you for your consideration of these views. Please do not hesitate to call me at (202) 772-2482 if you have any questions regarding these issues.

Sincerely,

Kenneth J. Kies