Notice 2005-10: Welcome (Mostly) Guidance on the New Repatriation Provisions

Author: Rollinson, Margie;
Mundaca, Michael;
Murillo, Jose, Ernst & Young

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 1, *Doc 2005-887, 2005 TNT 10-6*, 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 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 *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

[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).

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 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]

---

[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 spin-offs on that determination.
[10] Section 965(b)(2)(B).

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,

---

[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.

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 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 section 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

[14] *See* conference report at 302.

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 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 research and development 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 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, 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. jobs 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 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 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 other 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 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.