



Securities Industry Association

1425 K Street, NW • Washington, DC 20005-3500 (202) 216-2000 • Fax (202) 216-2119 •
www.sia.com, info@sia.com

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Ms. Barbara M. Angus
International Tax Counsel
Department of the Treasury
1500 Pennsylvania Ave., N.W.
Suite 1000
Washington, DC 20220

Dear Barbara:

On behalf of the Securities Industry Association ("SIA"),¹ I am writing to request guidance on several issues described briefly below arising under new Internal Revenue Code Section 965, which provides a temporary dividends received deduction to certain U.S. corporations receiving cash dividends from controlled foreign corporations (CFCs).

Section 965 was recently enacted as part of H.R. 4520, the "American Jobs Creation Act of 2004." SIA strongly believes that early Treasury and IRS guidance under this provision on as many issues as feasible is critical. The consequences of reaching an incorrect conclusion under the new provision are simply so significant that, as a practical matter, companies will be unable to utilize this important incentive provided by Congress to reinvest earnings of their foreign subsidiaries in the United States absent a high degree of certainty concerning the outcomes on several key issues. Clear and expedited guidance also will serve the important function of saving taxpayers and tax administrators alike many of the very substantial uncertainty costs associated with the new provision.

¹ The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs 780,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated an estimated \$209 billion in domestic revenue and \$278 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

SIA also would like to take this opportunity to thank the Treasury Department for its work with the tax-writing committees since the enactment of H.R. 4520 to clarify the intended operation of new Section 965. The early introduction of technical corrections legislation by Ways and Means Committee Chairman Thomas, Senate Finance Committee Chairman Grassley, and Senate Finance Committee Ranking Democrat Baucus is very helpful for taxpayer planning purposes. SIA supports passage of legislation addressing some of the most important ambiguities and glitches in the enacted Section 965. Of particular importance are the technical corrections clarifying that (i) there is no section 78 gross-up for foreign taxes associated with the deductible portion of a dividend and (ii) only expenses directly allocable to the deductible portion of a dividend are nondeductible.

Related party indebtedness

U.S. parent guarantee. Under Section 965(b)(3), the amount of dividends qualifying for the temporary dividends received deduction is reduced to the extent of any increase in CFC indebtedness to the U.S. parent company and to certain other related parties, as measured on two specified dates. Guidance should clarify that a guarantee by a U.S. parent company of the obligations of its CFC will not be treated as a loan from the U.S. parent in those cases in which it is reasonable to expect that the CFC will be able to adequately service its loans with its own cash flow. The guarantee should be ignored for purposes of calculating any increase in related party indebtedness unless the facts, including the existence of the guarantee, indicate that the U.S. parent rather than the CFC is properly considered the true borrower from the unrelated third party. See, e.g., *Plantation Patterns Inc. v. Commissioner*, 462 F.2d 712 (5th Cir. 1972), *cert. denied*, 409 U.S. 1076.

Clarification on this question is important because many CFCs will need to borrow in order to obtain the funds to make distributions under the new Section 965, and parent guarantees are common features of borrowings by CFCs. U.S. parent companies typically are able to obtain a significantly lower cost of financing than their subsidiaries, and the guarantee mechanism generally allows CFCs to obtain the benefits of this lower cost of funding.

Acquisitions and dispositions during the measurement period. As noted above, an increase in certain related party indebtedness of a CFC during the measurement period (measured as of the close of October 3, 2004, and as of the close of the last day of the taxable year for which the taxpayer has elected to have section 965 apply) has the effect of decreasing the amount of dividends received from CFCs that can benefit from the temporary dividends received deduction. Sec. 965(b)(3). Absent a technical correction to the statute or Treasury guidance ameliorating this result, any taxpayer making a material acquisition or undertaking an outbound incorporation of a significant trade or business may find, solely because of these transactions, that it cannot satisfy the

related party indebtedness test. Similarly, taxpayers undertaking an in-bound liquidation of a CFC or a spin-off of a CFC may appear to meet the test but may not feel confident that the IRS will accept such a measurement on audit.

Section 965(b)(3) is intended to limit the benefits of the temporary dividends received deduction in the case of CFC dividends funded by loans from related U.S. persons. However, any changes in related party indebtedness caused by normal acquisitions and dispositions of active businesses are unrelated to the lending transactions that Section 965(b)(3) was intended to proscribe. Further, it would distort economic decisions of taxpayers in meaningful ways to force them to either alter their normal acquisitions and dispositions decisions in order to preserve the one-time substantial benefits of the temporary dividends received deduction or forego the benefits of new Section 965 altogether. For these reasons, the SIA recommends that Treasury issue guidance under the authority of Section 7805 of the Internal Revenue Code permitting taxpayers undertaking acquisitions and dispositions (directly or indirectly) of a CFC during the measurement period to elect for purposes of the Section 965(b)(3) related party indebtedness calculation to treat all of these transactions as if they occurred immediately prior to October 3, 2004. SIA recommends that such election cover any acquisition or outbound transfer of an active trade or business, including an incorporation of an active trade or business, and any disposition, spin-off or in-bound liquidation of a CFC with an active trade or business. For this purpose, an active trade or business should be defined as set forth in the regulations under Section 355. Reg. Sec. 1.355-3(b)(2). The election should apply not only to transactions directly involving CFCs, but also to transactions in which CFCs are indirectly acquired or disposed of through the acquisition or disposition of a related corporation.

SIA also urges Treasury to support a technical correction to the statute to clarify the effects of acquisitions and dispositions of active trades or businesses on the related party indebtedness limitations of Section 965(b)(3).

Distributions by a disregarded foreign entity

The deductibility of distributions made to, or by, a disregarded foreign entity remains unclear. The only discussion of foreign disregarded entities is in a footnote to the Conference Report to H.R. 4520, which states that amounts treated as a dividend as a result of a "check-the-box" liquidation will not be eligible for the temporary dividends received deduction because the U.S. shareholder will not have received an actual cash distribution. Conf. Report at p. 66, N. 108. It would be helpful for guidance to address whether the deemed dividend would be deductible if the cash amount of the dividend was actually paid into the United States other than through a liquidating distribution, such as a loan by the disregarded foreign entity to its U.S. shareholder. Similarly, guidance should also address the deductibility of a cash dividend by a CFC to a long-standing foreign disregarded entity that is owned by the U.S. shareholder. If

such a dividend were not deductible, guidance should address whether the result would be different if the foreign disregarded entity lent the cash amount of the dividend to its U.S. shareholder.

Investment of the amount of the dividend in the United States

Debt pay down and share repurchases. Guidance should clarify the circumstances in which the amount of a dividend will be considered to be invested in the United States for purposes of Section 965(b)(4) when the U.S. corporation pays down its own debt or repurchases its shares. In appropriate cases, SIA believes that each of these uses should be considered to meet the requirement to invest in the United States under this section. While the list of permitted uses of the dividend that is included in Section 965(b)(4) (B) does not specifically refer to these uses, the list includes use for "the financial stabilization of the corporation for the purposes of job retention or creation." Further, the Conference Report to H.R. 4520 states that the statutory list is not intended to be exclusive. Conf. Report at p. 67. Both debt pay down and share repurchases can serve to stabilize and strengthen the financial position of the U.S. corporation, in part due to the positive effect each will have on future cash flows. Improving a U.S. corporation's prospects for current and future economic success within the United States would seem to meet the basic goals of the new section.

Detailed guidance on permitted investments in the United States under the new provision is particularly crucial since it will affect the ability of corporations to make the most economically efficient investments possible under the new provision.

Segregation of cash dividend. Section 965(b)(4) states that "the amount of the dividend" must be invested in the United States, suggesting that the cash dividend does not need to be segregated in a separate account and its expenditure traced to specific investment uses in order to preserve the temporary dividends received deduction. However, other language in the statute, such as the later reference in Section 965(b)(4)(B) to "the reinvestment of such dividend in the United States," can be read to suggest a need for tracing. Absent guidance that clearly provides there is no need to trace dividends received to specific uses, taxpayers could be expected to incur substantial costs to set up just such deduction protection mechanisms. No purpose would be furthered by having taxpayers incur the substantial costs and compliance burdens associated separate accounts and tracing disbursements to qualifying expenditures, and guidance should state that such actions are not necessary under the new provision.

Time constraints on investment in the United States. The statute does not provide a deadline for investment in the United States. Because the time frame

for investment is a crucial element of business planning, early guidance should alert taxpayers to any constraints on the timing of permitted U.S. investments.

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Thank you for your consideration of our views. Please do not hesitate to contact me (at 202-216-2031, or by email at pmcclanahan@sia.com) if you or your staff would find it helpful to discuss further any of these issues.

Sincerely,

Patti McClanahan
Vice President and Director for Tax Policy
Securities Industry Association