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IRS Provides Guidance on Repatriations under New Section 965

Background

Section 965 of the Internal Revenue Code, added by the American Jobs Creation Act of 2004 (P.L. 108-357) (the "Act"), allows a U.S. corporate shareholder of a controlled foreign corporations ("CFC") a temporary elective 85 percent dividends received deduction on certain repatriations of cash from the CFC. On January 13, 2005, the Internal Revenue Service released Notice 2005-10, providing the first detailed guidance on how it will interpret the new section.

This partial dividends received deduction is available for either the last tax year that started before the date of enactment of section 965 or the first tax year starting after the date of enactment (either 2004 or 2005 for a calendar year taxpayer). The section is intended as an incentive for taxpayers to repatriate earnings that might otherwise remain permanently or indefinitely invested by foreign subsidiaries. Accordingly, the benefits are available only for a single taxable year and only to the extent that dividends received exceed the average dividends received by the taxpayer from its CFCs during a specified base period. Congress also required that the repatriated dividends be paid in cash and be invested within the United States pursuant to a "dividend reinvestment plan" approved by the taxpayer's management and Board of Directors. Notice 2005-10 provides interim guidance in a number of areas where taxpayers had requested clarification of the statutory provisions.

Only Cash is Cash

As noted above, section 965 requires that a dividend be paid in "cash" in order to qualify for the partial dividends received deduction. Notice 2005-10 clarifies that cash can include foreign currency and can be transferred via wire transfer or check. Many taxpayers, however, were disappointed to learn that Treasury securities and other liquid assets generally thought of as cash equivalents will not qualify as "cash" for this purpose. It came as cold comfort to those taxpayers that conversion of such liquid assets into cash, distribution of the cash, and reinvestment of the cash in substantially similar or identical assets would be allowed. The IRS stated that it would not apply the step-transaction doctrine to recharacterize this sequence into a distribution of non-cash assets.

Regarding Disregarded Entities

Somewhat surprisingly, Notice 2005-10 requires that the cash be legally owned by the U.S. taxpayer seeking the benefit of section 965. A distribution to a disregarded entity owned by the U.S. taxpayer will not qualify unless the disregarded entity in turn distributes the cash to the taxpayer. This rule apparently applies regardless of whether the disregarded entity is formed under U.S. law or under foreign law, and regardless of whether the disregarded entity itself invests the cash within the United States. It is hard to understand the policy considerations advanced by this aspect of the Notice.

Associated Expenses

The amount of a dividend for section 965 purposes is not reduced by expenses incurred by the taxpayer as a result of the payment of the dividend (e.g., foreign withholding taxes). Thus, the amount of the dividends received deduction under section 965 will be calculated by reference to the full amount of the dividend. Similarly, though, the full amount of the dividend, unreduced by such expenses, must be invested by the taxpayer within the United States.

Domestic Reinvestment Plans

The IRS provided relatively little detail on the form or contents of a domestic reinvestment plan. Board approval of the plan may be prior or subsequent to the actual payment of the dividend. A single plan is sufficient for an entire consolidated group. The plan must describe the intended investments "in reasonable detail and specificity" such that a subsequent audit may confirm that the expenditures were consistent with the plan. The plan may provide for alternative investments — the taxpayer need not lock itself into a specific course of action. A domestic reinvestment plan may include an investment that the taxpayer had anticipated making prior to adoption of the plan, even if the taxpayer had already budgeted and earmarked other funds for the investment.

The IRS specified certain forms of expenditures that will or will not be treated as investments within the United States. As a threshold matter, payments must be made in the form of cash. Investments paid for with stock will not qualify, and investments paid for with a note will qualify only to the extent that cash is paid to reduce the principal amount of such note. Payments must be made to unrelated persons. Payments of executive compensation will not qualify. Nor will dividends or stock redemptions/repurchases.

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In general, payments for physical plant or infrastructure located within the United States will qualify as investments within the United States. Payments need not, however, be for physical assets; investments in intangible assets to be used within the United States are allowed. A look-through rule generally will be applied to treat the acquisition of a 10 percent or greater interest in a business entity as a proportionate acquisition of the assets of that entity.

Payments for employee training, research and development, advertising, or similar services can qualify provided that the services are performed within the United States. In addition, the repayment of debt or the funding of a qualified retirement plan will qualify as a permissible investment within the United States provided that the reduction in debt is meaningful (i.e., a similar amount is not borrowed immediately before or after the repayment as part of a single plan), and the reduction in debt is expected to contribute to the financial stabilization of the taxpayer for purposes of job retention or job creation within the United States. This standard will be met if the taxpayer's reasonable business judgment is that the resulting financial stabilization will be a positive factor in its ability to retain and create jobs in the United States.

No Tracing Required, Safe Harbor Available

The Notice makes clear that the ability to trace the proceeds of the repatriation dividend to a qualifying expenditure is not a pre-requisite to claiming the dividends received deduction under section 965. However, the Notice does state that closer scrutiny may result where the expenditures specified in the dividend reinvestment plan do not occur for several years while other non-qualifying expenditures are made in the interim. In such circumstances, establishing a segregated asset account to hold the proceeds of the repatriation dividend would be a positive factor in establishing the taxpayer's intent to comply with the dividend reinvestment plan, and thus qualify for the dividends received deduction.

Regardless of whether a taxpayer establishes a segregated asset account, the Notice specifies that each taxpayer must attach a statement to its return detailing the progress of its expenditures under the dividend reinvestment plan. The statement is required for the year for which the taxpayer elects section 965 and each subsequent year until all of the repatriated funds have been expended pursuant to the dividend reinvestment plan.

Lastly, and perhaps most importantly, the Notice provides a safe harbor under which the IRS will deem the taxpayer to have demonstrated permissible reinvestment of the repatriation dividends if:

1. At least 60 percent of the funds have been spent (or are the subject of a binding contract with unrelated parties) by the close of the second taxable year after the year for which the taxpayer elected to apply section 965;
2. The expenditures are of a form explicitly permitted by Notice 2005-10; and
3. The taxpayer complies with the annual reporting requirements otherwise set forth in Notice 2005-10.

For more information, please contact Seth Green at (202) 862-7849 or smg@capdale.com.

IRS Audit Plans For Private Foundations And Publicly-supported Charities

Late in 2004, the IRS announced a revamped approach to its audit plans for private foundations and publicly-supported charities. The changes were sparked by media reports during the year laying out concerns at particular foundations and charities, oversight hearings by the Senate Finance Committee, and an enhanced capability by the IRS to identify and react to the information reported on Forms 990 and 990-PF. Approaches to compliance concerns, however, have had to be tempered by the budget realities of the IRS and the Exempt Organizations Division in particular. Accordingly, the IRS has announced a new approach to audits, focusing on a few discreet areas and issues. These will include private foundations, community foundations, donor-advised funds, supporting organizations, consumer credit counseling organizations, compensation, terrorist fundraising and abusive tax transactions.

Private Foundations

The IRS has announced that it intends to conduct audits of 400 private foundations, including 200 "non filing" private foundations and 200 foundations with assets of between $100,000 and $50 million. "Non-filing" private foundations are those carried as active private foundations on the IRS master file of tax-exempt organizations, but for which the IRS has no record of the filing of a Form 990-PF. Non-filers will be selected for audit on a random basis.

IRS targeted audits will include a review of compensation at institutions that have been identified by the Exempt Organizations Compliance Unit ("EOCU") at the Ogden Service Center. The EOCU is planning on contacting approximately 2,000 foundations and publicly-supported charities to obtain information about their compensation practices. The IRS estimates that these inquiries will result in about 250 audits focusing on potentially excessive compensation. The organizations selected for audit will likely contain both foundations and charities. Another audit project will address organizations involved in international grant making. This project also will target both foundations and charities and is an outgrowth of IRS efforts to eliminate any use of charitable funds for terrorist purposes. IRS officials have stated that the results of the review of international grant making could result in the promulgation of new rules in this area.

Publicly-Supported Charities

For publicly-supported charities, the risks of an IRS audit are greatest for community foundations and other organizations offering donor-advised funds to the public, supporting organizations (those entities described in section 509(a)(3) of the

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Internal Revenue Code), and consumer credit counseling organizations. While the IRS has not yet publicly announced the number of organizations that will be involved in the projects or any defining parameters, such as asset or income size, it has promised to do so. It also has promised to publicly release the check sheets that revenue agents will be using to collect data for analysis purposes. If the IRS follows through with these promises, organizations will have a good idea of the nature and scope of any IRS inquiry. Based on public statements, the IRS is especially concerned about community foundations and donor-advised funds that provide benefits back to donors, particularly in the form of inflated charitable contribution deductions, loans to donors, and the payment of donor expenses.

For consumer credit counseling organizations, the risk of an IRS audit is particularly acute, as IRS officials have publicly stated that already organizations representing over 50% of the assets of the industry are under review.

In addition to the preceding focused audit projects, the IRS reviews of compensation and international grant making described above for private foundations will also impact publicly supported charities, as the selection of organizations for review will be based on activities rather than classification as a foundation or charity.

The IRS review of supporting organizations, which are charities classified under section 509(a)(3), is currently underway and consists of audits of organizations that the IRS believes may be funneling inappropriate benefits back to their donors and neglecting the requirement that "support" actually be provided to the identified supported organization. The IRS has apparently identified particular organizations for review based on media reports, complaints, and its own research, in which it is increasingly making use of the Internet.

The final area of audit focus by the IRS deals with those foundations and charities that are acting as "accommodation parties" or facilitators of abusive tax planning schemes designed to provide an unwarranted tax benefit to a party that would otherwise be subject to tax. The IRS has determined that many abusive arrangements require the cooperation of an organization that is "tax indifferent," that is, its income is exempt from tax and, consequently, it has no need for expenses or other deductions used in calculating taxable income. The arrangements purport to shelter income in the tax indifferent party though a variety of structures that the IRS contends have no economic reality. Expect the agency to aggressively apply the tax shelter promotion penalties in sections 6700 and 6701 in the pursuit of these arrangements, as well as the more well-known excise taxes of Chapter 42 of the Code, and even revocation of tax-exemption in particular cases.

For more information, please contact Marcus Owens at (202) 862-5020 or mso@capdale.com.

Changes to Individual Expatriation Rules

The Act modified, and generally strengthened, the income and transfer tax rules applicable to individuals who relinquish their U.S. citizenship or terminate their long-term U.S. residence (an "expatriate"). These rules have been the subject of continuing Congressional debate ever since they were substantially modified in 1996. The Act adopts certain recommendations made by the Joint Committee on Taxation staff in a 2003 report ("2003 JCT Report") that generally questioned the effectiveness of the 1996 changes. The new rules are applicable to individuals who expatriate after June 3, 2004.

Prior Law

Under prior law, an individual considered to have expatriated for a principal tax avoidance purpose was required to pay U.S. income tax on items of U.S. source income for 10 years following expatriation at the higher of the rates applicable to nonresident aliens or to U.S. citizens and residents (the "alternative tax regime"). Expatriation was considered to have occurred at the date prescribed for citizens under nationality law and for long-term residents under the tax residence rules. Tax avoidance was presumed if an individual's net average U.S. income tax liability in the five years preceding expatriation was $100,000 or more ("income tax liability test") or if his net worth at expatriation exceeded $500,000 ("net worth test"). Both figures were indexed for post-1996 years and, for expatriations occurring in 2004, were $124,000 and $622,000, respectively. Exceptions were available for certain categories of individuals if they obtained a ruling from the IRS that tax avoidance was not a principal purpose of their expatriation. In cases in which the Service was unable to make a definitive determination, it was authorized to issue a limited ruling that lifted the statutory presumption, but left the taxpayer subject to subsequent examination, if the taxpayer's ruling request was considered to be complete and made in good faith. U.S. source income was defined to include gains from the sale or exchange of property located in the U.S., including gains from the sale or exchange of securities of U.S. issuers, and income derived from former controlled CFCs considered controlled by an expatriate within two years prior to expatriation. In addition, certain gains arising in otherwise non-taxable transactions that resulted in a change of future income source from U.S. to non-U.S. were required to be recognized as U.S. source income.

Prior law also applied the presumptive tax avoidance standards to expatriates for certain transfer tax purposes. In particular, during the 10-year post-expatriation period, an expatriate remained subject to U.S. gift tax on transfers of intangible property located in the United States and, at death, an expatriate's estate was subject to estate tax on stock of a foreign corporation considered to have been controlled by the decedent to the extent of the value of the foreign cor-

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poration's underlying U.S. property.

Finally, under prior law, an expatriating U.S. citizen was required to provide a statement of net worth to the Department of State at the time of the expatriating act, and a departing long-term resident was required to provide the same statement with the tax return for the year of expatriation. In addition, an expatriate was required to file a U.S. tax return, including a worldwide income statement, in any of the 10 years following expatriation in which he had U.S. income subject to tax.

The 1996 expatriation rules were intended to override the provisions of inconsistent income and transfer tax treaties for 10 years following enactment.

Act Changes

Section 804 of the Act generally leaves the 10-year alternative tax regime on U.S. source income in place, but removes the requirement that an individual have a tax avoidance purpose and dispenses with the ruling procedure. The income tax liability test threshold is changed only slightly to "greater than" $124,000 (indexed annually beginning in 2005), but the net worth test standard is increased substantially to $2,000,000. In addition, the Act adds a third test, providing that an expatriate certify full compliance with all U.S. tax requirements for the five years preceding expatriation. Exceptions to the provision are limited to certain dual nationals at birth having no "substantial contacts" with the United States (i.e., never a U.S. tax resident or citizen and not more than 30 days of U.S. presence in any of the 10 years preceding expatriation) and minors expatriating before age 18 who were born in the United States to non-citizen parents and who have not been in the United States more than 30 days in the 10 years preceding expatriation.

The Act amends the expatriation gift tax rules to add a provision that parallels the expatriation estate tax rule and imposes tax on gifts of shares of a foreign corporation considered to be controlled by the expatriate to the extent of such foreign corporation's underlying U.S. property during the 10-year post-expatriation period.

The Act also adds a provision for determining when an individual is considered to have expatriated for tax purposes. It provides that an individual will continue to be treated as a U.S. citizen or long-term resident until both giving notice of expatriation to the appropriate Government department or agency and providing an information statement required by section 6039G. That section formerly required only that a former citizen provide an initial information statement at the date of expatriation, and that a former long-term resident provide the statement with the tax return for the year of expatriation. In addition, under prior law, an expatriate was required to file a U.S. tax return in the 10 years following expatriation only in years for which there was U.S. source income subject to tax. Under the Act's changes, the timing of the initial information statement in the case of a departing long-term resident is unclear; if it is not required until filing of the tax return for the year of expatriation, the individual will remain a U.S. resident until such time. Further, the amended statute now requires that an expatriate file a statement (presumably including a tax return) for each of the 10 post-expatriation years regardless of whether the expatriate had any U.S. source taxable income for such year.

Finally, section 804 adds a new short-term residence rule to the expatriation tax provisions. Under it, an individual otherwise subject to the expatriation provisions will be subject to income and transfer taxes as a U.S. citizen or resident during any of the 10 post-expatriation years if physically present in the United States for more than 30 days in that year. A limited exception is provided for up to 30 additional days of U.S. presence if the expatriate is performing services in the United States for an unrelated employer.

The legislative history to section 804 of the Act does not address the issue of treaty override. Presumably, since the fundamental taxing provision of the alternative tax regime has neither been amended nor re-enacted, the 1996 treaty override provision remains intact until August 21, 2006. Nor does the Act address the so-called "Reed amendment" provision of immigration reform enacted in 1996. That provision bars re-entry to the United States for former citizens who expatriated for a principal tax avoidance reason in the opinion of the Attorney General. Because of certain statutory defects, it has never been implemented. The 2003 JCT Report recommended changing the provision to bar U.S. re-entry only to former citizens who have not fully complied with their expatriation tax obligations, but this was not included with the Act's changes, notwithstanding that section 804's provisions generally follow the 2003 JCT Report recommendations.

For more information, please contact Michael Pfeifer at (202) 862-5085 or mgp@capdale.com.