

GUIDANCE ON REPATRIATION OF FOREIGN EARNINGS UNDER THE AMERICAN JOBS CREATION ACT OF 2004

FEBRUARY 2, 2005

The American Jobs Creation Act of 2004 added section 965 of the Internal Revenue Code of 1986, as amended (the "Code"),¹ as a temporary incentive for repatriation of foreign earnings. In general, and subject to several limitations, section 965 provides an election under which a U.S. corporate shareholder may benefit from a one-time deduction of 85 percent of certain cash dividends received from a controlled foreign corporation (a "CFC").²

The Internal Revenue Service (the "IRS") released Notice 2005-10 (the "Notice"), the first in a series of notices to provide guidance on section 965. This memorandum briefly summarizes such guidance, including the parameters for a domestic reinvestment plan, the permitted expenditures in the U.S. for which repatriated funds may be used, the safe harbor mechanism for taxpayers to use in establishing that the domestic reinvestment plan requirement is satisfied, as well as information reporting requirements.

REQUIREMENTS FOR A DOMESTIC REINVESTMENT PLAN

As a condition to receipt of the deduction under section 965, taxpayers must invest the amount of the dividend in the U.S. pursuant to a domestic reinvestment plan. A domestic reinvestment plan is a written plan prepared by the taxpayer describing in "reasonable detail and specificity" the planned investment in the U.S. of the amount of the dividend.³ The Notice provides that the domestic reinvestment plan should set forth, at a minimum, (i) the total dollar amount for each respective principal investment (and each alternative investment, if any) and (ii) a reasonable time period during which the taxpayer anticipates completing all such

¹ All section references, unless otherwise indicated, are to the Code.

² The dividends eligible for the deduction are limited to cash dividends that exceed average repatriated earnings over three of the five most recent taxable years ending on June 30, 2003 ("extraordinary dividends"). Such extraordinary dividends may not exceed the greater of (i) \$500 million or (ii) the amount reported as earnings permanently invested outside the U.S. in certain audited financial statements (or calculated by reference to the tax liability attributable to such earnings, if such earnings are not directly shown). In addition, dividends must be reduced by the net increase, if any, in related-party indebtedness during the period from October 3, 2004 until the end of the taxable year for which the election is made.

³ Provided that a sufficient amount of funds are invested in "permitted investments," taxpayers will generally not be required to segregate the dividends or trace the dividends to specific investments.

investments.⁴ Expenditures made in the election year, but prior to the payment of the cash dividend (or prior to the adoption of the domestic reinvestment plan), will qualify as permitted investments provided they otherwise qualify as permitted investments.

PERMITTED INVESTMENTS

The Notice describes certain expenditures that, if made pursuant to a domestic reinvestment plan, are investments in the U.S. eligible for the one-time deduction ("permitted investments").⁵ The list of permitted investments is not intended to be exclusive.

Except as otherwise indicated, expenditures are only eligible for deduction to the extent they satisfy the following requirements: (i) payments are made in cash to unrelated persons; (ii) the assets, property rights (in the case of intangible property), or activities to which such expenditures relate are located, used, or performed in the U.S., respectively and (iii) the taxpayer bears the cost of activities necessary to create, develop, improve, or acquire permitted investments if such activities are not performed by the taxpayer's employees.

Funding of Worker Hiring, Training and Other Compensation

Permitted investments include compensation-related expenditures (other than executive compensation) incurred for existing and newly hired workers, including funding a qualified employee benefits plan (within the meaning of section 401(a)).⁶

Infrastructure and Capital Investments

Permitted investments include expenditures incurred to purchase, develop, rent, license or improve physical installations and facilities that support the taxpayer's business and other assets integral to the conduct of a business, such as property, plant and equipment, communications and distributions systems, computer hardware and software, databases and supporting equipment.

⁴ Prior to the receipt of the cash dividend, the domestic reinvestment plan must be approved by the corporation's senior management (e.g., the chief executive officer or comparable official) and subsequently approved by the Board of Directors (or similar group). The domestic reinvestment plan may not be amended or modified after payment of the dividend to which such plan relates.

⁵ There is no requirement that there be an increase in such expenditures over prior expenditures.

⁶ For expenditures incurred to fund a qualified employee benefits plan under this category, the taxpayer may use any reasonable method to apportion funding between executive and non-executive compensation and employee services performed within and without the U.S.

Research and Development

Permitted investments include expenditures incident to the development or improvement of products but not expenditures for quality control testing, efficiency surveys, management studies, consumer surveys, advertising or promotions.

Financial Stabilization of the Corporation for the Purposes of Job Retention or Creation

Repayment of Debt. Debt repayment (other than repayment of intercompany obligations) is a permitted investment if, at the time of approving the domestic reinvestment plan, it is the taxpayer's reasonable business judgment that such debt repayment will be a positive factor in its ability to retain and create jobs in the U.S.⁷ and the taxpayer does not incur debt on substantially the same terms pursuant to a plan or intent existing at the time of debt repayment.

Taxpayers are not required to show a net global reduction in indebtedness of the taxpayer's corporate group in order for the repayment of debt to be a permitted investment. Thus, a CFC may incur third-party debt to fund a cash dividend to its U.S. corporate shareholder provided that, in substance, the U.S. corporate shareholder is not the obligor of the debt nominally incurred by the CFC.⁸

Qualified Plan Funding. Payments to fund a qualified employee benefits plan (within the meaning of section 401(a)) are permitted investments so long as it is the taxpayer's reasonable business judgment, at the time the domestic reinvestment plan is approved, that such payments will result in financial stabilization of the corporation and will be a positive factor in its ability to retain and create jobs in the U.S.⁹

Other. Expenditures other than repayment of debt and qualified plan funding can be permitted investments if (i) such expenditures reduce the financial constraints on the taxpayer's U.S. operations and (ii) at the time the domestic reinvestment plan is approved, it is the taxpayer's reasonable business judgment that such reduction in financial constraints will be a positive factor in its ability to retain and create jobs in the U.S.

⁷ Taxpayers can demonstrate this standard by, for example, developing a plan that evidences the expected use of savings attributable to the expenditure principally for expenditures incurred in connection with permitted investments.

⁸ Generally, a U.S. parent should be able to guarantee a CFC's debt so long as the expectations of the parties are that the CFC would pay debt service from its own cash flows. See Plantation Patterns v. Comm'r, 462 F.2d 712 (5th Cir. 1972).

⁹ Taxpayers who satisfy this requirement are not required to demonstrate the extent to which (i) the plan covers current employees or (ii) persons covered by the plan performed services in the U.S.

Acquisitions of Interests in Business Entities

Permitted investments include acquisitions of interests in domestic or foreign business entities to the extent that (i) such business entity owns assets, the total value of which would be permitted investments under the Notice and (ii) the taxpayer directly or indirectly owns an interest representing at least 10 percent of the value of such business entity after the acquisition.

Advertising and Marketing

Permitted investments include expenditures for advertising and marketing with respect to enhancing the corporation's trademarks, trade names, brand names, or similar intangible property.

Intangible Property

Permitted investments include expenditures to purchase or license rights to intangible property.

NON-PERMITTED INVESTMENTS

Non-permitted investments are typically investments that do not reasonably add to the viability of the taxpayer or provide economic stimulus to the U.S. economy. Under the Notice, non-permitted investments include the following expenditures:

- executive compensation;
- intercompany transactions;
- dividends and other distributions with respect to stock;
- stock redemptions;
- portfolio investments in business entities;
- investments in debt instruments or other evidences of indebtedness; and
- tax-related payments.

INFORMATION REPORTING REQUIREMENTS AND SAFE HARBOR

The Notice sets forth certain information reporting requirements for taxpayers electing to repatriate dividends under section 965. In general, electing taxpayers must file IRS Form 8895 (not yet available) and other supporting documentation for the taxable year of election and

for each subsequent tax year in which the taxpayer's investment obligations under the domestic reinvestment plan have not been completed.

The Notice also provides a safe harbor mechanism for taxpayers to use in establishing that the domestic reinvestment plan requirement is satisfied. To meet the safe harbor, expenditures comprising at least 60 percent of the amount of total funds with respect to permitted investments to be made pursuant to the domestic reinvestment plan must meet the following requirements: (i) such expenditures have been made, or are the subject of a binding contract, by the end of the second taxable year following the taxable year for which the section 965 election is made; (ii) expenditures consist solely of the permitted investments enumerated in the Notice and (iii) the taxpayer makes certain representations with respect to the foregoing.

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The foregoing is intended only as a general summary, and section 965 is more complex in its entirety. Please contact Steven C. Todrys (212-455-3750; stodrys@stblaw.com), John Creed (212-455-3485; jcreed@stblaw.com) or any other member of our Tax Department if you have questions or comments.

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