

## Part III. Administrative, Procedural, and Miscellaneous

### Section 965 — Limitations on Dividends Received Deduction and Other Guidance

#### Notice 2005-38

##### SECTION 1. OVERVIEW

This notice is the second in a series of items of published guidance regarding new section 965 of the Internal Revenue Code (Code). It supplements guidance previously set forth in Notice 2005-10, 2005-6 I.R.B. 474, which primarily addressed requirements regarding a domestic reinvestment plan described in section 965(b)(4). This notice primarily addresses the limitations, described in section 965(b)(1), (2), and (3), on the amount of dividends that a corporation that is a U.S. shareholder of a controlled foreign corporation may treat as eligible for the dividends received deduction under section 965(a) (DRD or section 965(a) DRD), including the effects of certain transactions on such limitations.

The Treasury Department and the Internal Revenue Service (IRS) intend to issue additional guidance concerning section 965 to address certain issues arising with respect to a U.S. corporation's computation of its tax liability, including the availability of foreign tax credits, when section 965 is applied. The Treasury Department and the IRS expect to issue regulations that incorporate the guidance provided in Notice 2005-10, this notice, and any subsequent guidance addressing section 965.

The remainder of this notice is divided into 14 sections. Section 2 provides background with respect to the issues addressed in this notice. Section 3 sets forth general principles that apply in determining the amount of cash dividends received by a U.S. shareholder that is considered extraordinary for purposes of section 965(b)(2). Section 4 sets forth general principles that apply in determining the maximum amount of dividends eligible under section 965(b)(1) to be taken into account under section 965(a). Section 5 addresses the taxable year to which sec-

tion 965 applies. Section 6 then addresses the effects of certain transactions on the determination of a U.S. shareholder's limitations determined under sections 3 and 4. Section 7 sets forth guidance and principles for determining under section 965(b)(3) the amount of related party indebtedness that reduces the amounts taken into account under section 965(a), including special adjustments made as a result of certain transactions. Section 8 provides guidance regarding the impact of certain transactions on domestic reinvestment plans. Section 9 addresses other issues arising under section 965, including the application of section 78, the expenses disallowed under section 965(d)(2), and the computation of the alternative minimum tax. Section 10 addresses reporting and other administrative requirements. Section 11 sets forth transition rules that apply to certain taxpayers that, prior to the issuance of this notice, either adopted a domestic reinvestment plan or filed a tax return for a taxable year to which section 965 applies. Section 12 describes the effect of this notice on other documents. Section 13 provides the effective date of this notice, and section 14 provides information required under the Paperwork Reduction Act of 1995. Finally, section 15 provides drafting information.

##### SECTION 2. BACKGROUND

###### .01 Section 965 — In General

The American Jobs Creation Act of 2004 (P.L. No. 108-357) (the Act), enacted on October 22, 2004, added new section 965 to the Code. In general, and subject to limitations discussed below, section 965(a) provides that a corporation that is a U.S. shareholder of a controlled foreign corporation (CFC) may elect, for one taxable year, an 85 percent DRD with respect to certain cash dividends it receives from its CFCs.

Section 951(b) defines the term "U.S. shareholder" with respect to any foreign corporation as a U.S. person who owns (within the meaning of section 958(a)), or is considered to own (under the construc-

tive ownership rules of section 958(b)), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. Section 965(c)(5)(A) provides that all U.S. shareholders that are members of an affiliated group filing a consolidated return under section 1501 are treated as one U.S. shareholder. For purposes of this notice, the term "U.S. shareholder" means, unless otherwise indicated, a domestic corporation that, at any time after the beginning of the base period (defined below), is a U.S. shareholder (as defined in section 951(b)) with respect to a CFC and that owns (within the meaning of section 958(a)) stock of such CFC.

For purposes of section 965, the term "dividends" includes cash amounts included in gross income as dividends under sections 302 and 304, but does not include amounts treated as dividends under section 78 or 1248 or, in certain cases, section 367.<sup>1</sup> H.R. Conf. Rep. No. 108-755, at 314-15 (2004). Also for this purpose, a cash dividend includes a cash distribution from a CFC that is excluded from gross income under section 959(a) (regarding distributions of previously taxed income (PTI)) to the extent of inclusions under section 951(a)(1)(A) as a result of a cash dividend during the election year to: (1) such CFC from another CFC in a section 958(a) chain of ownership; or (2) any other CFC in such chain of ownership from another CFC in such chain of ownership, but only to the extent of cash distributions described in section 959(b) made during such year to the CFC from which such U.S. shareholder received such distribution.

Section 965(b) imposes four limitations on the section 965(a) DRD. These limitations are discussed in detail below in paragraphs .02 through .05 of this section.

Section 965(d) and (e) provide special rules that limit the use of foreign tax credits and the deduction of certain expenses to offset the nondeductible portion of section 965(a) dividends, respectively. See section 9.01 of this notice. These rules will be addressed in greater detail in a subsequent

<sup>1</sup> Dividends resulting from liquidations qualifying under section 332 to which section 367(b) applies qualify as cash dividends to the extent the U.S. shareholder actually receives cash as part of the liquidation. Section 965(c)(3). A deemed liquidation effectuated through an election under Treas. Reg. §301.7701-3(c), however, does not by itself result in an actual distribution of cash as required under section 965. See H.R. Conf. Rep. No. 108-755, at 315, n. 108 (2004).

notice that the Treasury Department and the IRS expect to issue soon.

Section 965(f) provides that taxpayers may elect the application of section 965 for either the taxpayer's last taxable year which begins before October 22, 2004, or the taxpayer's first taxable year which begins during the one-year period beginning on October 22, 2004. The election must be made on or before the taxpayer's due date (including extensions) for filing its Federal income tax return. See Notice 2005-10; see also H.R. Conf. Rep. No. 108-755, at 314, n. 107 (2004). The taxable year for which a taxpayer elects to apply section 965 will be referred to in this notice as the "election year."

### .02 Extraordinary Dividends

Section 965(b)(2) provides that only those cash dividends (within the meaning of section 965(a)) received from CFCs during the U.S. shareholder's election year that are considered "extraordinary" are eligible for the section 965(a) DRD. Cash dividends received by the U.S. shareholder during the election year are considered extraordinary only to the extent such dividends exceed the annual average for the base period years of the following items reported on the U.S. shareholder's tax return as filed (including any amended returns that were filed on or before June 30, 2003): (1) dividends received during each base period year by such shareholder from CFCs<sup>2</sup>; (2) amounts includible in such shareholder's gross income for each base period year under section 951(a)(1)(B) (regarding investments in United States property under section 956) with respect to CFCs; and (3) amounts that would have been included for each base period year but for section 959(a) with respect to CFCs.<sup>3</sup>

The term "base period" in this notice means the five most recent taxable years of the U.S. shareholder that end on or before June 30, 2003. The term "base period inclusion" in this notice means any amount described in (1), (2), or (3) of the preceding paragraph, for any of the U.S. shareholder's taxable years in the base period. Under section 965(c)(2)(A), the term "base period years" generally in-

cludes only three taxable years in the U.S. shareholder's base period, determined by disregarding the years in the base period for which the base period inclusions are the highest and the lowest. However, if the taxpayer has fewer than five taxable years ending on or before June 30, 2003, then all taxable years ending on or before that date are considered base period years. The average of the U.S. shareholder's base period inclusions for its base period years is referred to in this notice as the "base period amount."

Section 965(c)(2)(C)(i) sets forth a general rule applicable to companies entering and exiting corporate groups, which provides that for purposes of determining the base period inclusions (and ultimately the base period amount), rules similar to the rules of section 41(f)(3)(A) and (B) apply. Section 41 generally provides for an incremental credit for qualified research activities, but only to the extent that current year research expenditures exceed the base amount for that year. For purposes of section 41, the base amount is computed by multiplying a measure of the taxpayer's qualified research expenses during a specified historical period by its average annual gross receipts for the four years immediately preceding the credit year. Section 41(f)(3)(A) and (B) generally provide that, as a result of certain acquisitions and dispositions, a taxpayer may increase or decrease the amount of its qualified research expenses and gross receipts to the extent that such amounts are attributable to the acquired or disposed of portion of a trade or business of the taxpayer.

In addition to the general references to section 41(f)(3)(A) and (B), section 965(c)(2)(C)(ii) provides a special rule for distributions during the base period of stock of a U.S. shareholder to which section 355 (or so much of section 356 that relates to section 355) applies. Under this special rule, the U.S. shareholder, the stock of which is distributed, is treated as having been in existence for the same period that the distributing corporation has been in existence. Further, the base period inclusions of the distributing and controlled corporations prior to the distribution are, in general, allocated between

such corporations on the basis of their respective interests in the CFCs giving rise to such inclusions immediately after such distribution. Section 965(c)(2)(C)(ii) also provides that this rule does not apply if neither the controlled corporation nor the distributing corporation is a U.S. shareholder of such CFCs immediately after the distribution.

### .03 Maximum Amount Eligible for Section 965(a) — Greater of \$500 Million or Permanently Reinvested Earnings

Section 965(b)(1) limits the amount of dividends eligible for the section 965(a) DRD to the greatest of the following three amounts: (1) \$500 million (\$500 million limitation); (2) the amount shown on the taxpayer's applicable financial statement as earnings permanently reinvested outside the United States; or (3) in the case of an applicable financial statement that does not show a specific amount of earnings permanently reinvested outside the United States but that does show a specific amount of tax liability attributable to such earnings, the amount of such liability divided by 0.35. If the applicable financial statement does not show a specific earnings or tax liability amount, then the \$500 million limitation applies. The section 965(b)(1) amount shown on the taxpayer's applicable financial statement as earnings permanently reinvested outside the United States and the amount shown as a specific amount of tax liability attributable to such earnings divided by 0.35 is referred to in this notice as "APB 23 limitation."

Under section 965(c)(1), the term "applicable financial statement" means the most recently audited financial statement (including notes and other documents which accompany such statement) which is certified on or before June 30, 2003, as being prepared in accordance with generally accepted accounting principles, and which is used for the purposes of a statement or report to creditors or shareholders or for any other substantial nontax purpose. If the taxpayer is required to file with the Securities and Exchange Commission, the audited financial statement must be so filed on or before June 30,

<sup>2</sup> For this purpose, both cash and non-cash dividends received are taken into account. See section 965(b)(2)(B)(i).

<sup>3</sup> For this purpose, distributions of PTI for any base period year do not include distributions excluded from gross income by reason of an amount described in section 965(b)(2)(B)(ii) (relating to investments in United States property) with respect to a prior taxable year.

2003, to qualify as an applicable financial statement. The legislative history states:

[APB 23 limitation] refers to elements of Accounting Principles Board Opinion 23 (“APB 23”), which provides an exception to the general rule of comprehensive recognition of deferred taxes for temporary book-tax differences. The exception is for temporary differences related to undistributed earnings of foreign subsidiaries and foreign corporate joint ventures that meet the indefinite reversal criterion in APB 23. H. R. Conf. Rep. No. 108–755, at 315, n. 111 (2004). The last day covered by the applicable financial statement is referred to in this notice as the “APB 23 determination date.”

Section 965(c)(5) provides special rules for applying section 965 to controlled groups of corporations. First, section 965(c)(5)(B) provides that all corporations treated as a single employer under section 52(a) (section 52(a) group) are limited to one \$500 million limitation, and the limitation must be divided among such corporations under regulations prescribed by the Secretary. A section 52(a) group includes all corporations that are members of a controlled group of corporations within the meaning of section 1563(a) substituting, however, “more than 50 percent” for “at least 80 percent” throughout section 1563(a)(1), and making the determination without regard to section 1563(a)(4) and (e)(3)(C). Second, section 965(c)(5)(C) provides that if a financial statement is an applicable financial statement for more than one U.S. shareholder, APB 23 limitation is divided among such shareholders under regulations prescribed by the Secretary.

#### .04 Increase in Related Party Indebtedness

Section 965(b)(3) provides that the amount of a U.S. shareholder’s dividends otherwise eligible for the deduction under section 965(a) are reduced by any increase in the indebtedness of the CFC to any related person (as defined in section 954(d)(3)) between October 3, 2004, and the close of the taxable year for which the election under section 965 is in effect.

For this purpose, all CFCs with respect to which the taxpayer is a U.S. shareholder are treated as a single CFC and, therefore, indebtedness between CFCs is disregarded for this purpose. See H.R. Conf. Rep. No. 108–755, at 314, n. 109 (2004). Section 965(b)(3) is intended to prevent a deduction from being claimed with respect to a section 965 dividend where the dividend is financed, directly or indirectly, by the U.S. shareholder. In such a case, there may be no net repatriation of funds, and thus it is inappropriate to allow a deduction under section 965(a). H.R. Conf. Rep. No. 108–755, at 315 (2004).

#### .05 Investment in the United States Pursuant to a Domestic Reinvestment Plan

Section 965(b)(4) requires a U.S. shareholder claiming a section 965(a) DRD with respect to a dividend to invest the amount of the dividend in the United States pursuant to a domestic reinvestment plan. The domestic reinvestment plan must be approved by the taxpayer’s president, chief executive officer, or comparable official before the payment of the dividend and subsequently approved by the taxpayer’s board of directors, management committee, executive committee, or similar body. The domestic reinvestment plan must provide for the investment of the dividend in the United States (other than as a payment for executive compensation), including as a source for the funding of worker hiring and training, infrastructure, research and development, capital investments, or the financial stabilization of the corporation for the purposes of job retention or creation. This list is not intended to be exclusive. H.R. Conf. Rep. No. 108–755, at 316 (2004). For additional guidance with respect to domestic reinvestment plans, see sections 8 and 9 of this notice and Notice 2005–10.

### SECTION 3. BASE PERIOD AMOUNT — GENERAL PRINCIPLES

#### .01 Determination of Base Period Amount

(a) *In general.* A U.S. shareholder determines its base period inclusions and its

base period amount by applying the rules of section 965(b)(2)(B) and (c)(2) with respect to CFCs for which it was a U.S. shareholder at any time during its base period.

(b) *Consolidated groups.* A consolidated group<sup>4</sup> determines its base period inclusions by first aggregating the base period inclusions of each of the members in its group. It then determines its base period amount by determining the average of such inclusions as provided under section 965(b)(2)(B) and (c)(2).

(c) *Short taxable years.* Taxable years of fewer than 12 months are taken into account as taxable years for purposes of determining the base period years pursuant to section 965(c)(2). In addition, base period inclusions in a taxable year of fewer than 12 months are not annualized or otherwise adjusted for purposes of calculating the base period amount.

(d) *Intermediary pass-through entities.* The Treasury Department and the IRS expect to issue guidance soon on the treatment of distributions to intermediary pass-through entities owned by U.S. shareholders for purposes of section 965(b)(2)(B)(i).

(e) *Example.* The following example illustrates the application of section 965(b)(2) and this section 3.01.

*Example.* (i) *Facts.* USP is the common parent of a consolidated group that includes USP’s wholly owned subsidiaries US1 and US2. US1 and US2 each wholly owns a foreign corporation, CFC1 and CFC2, respectively. The USP consolidated group maintains a taxable year ending July 31. US1 received a \$100x dividend from CFC1 in each of the consolidated taxable years ending July 31, 1996, 1997, and 1998. US2 received a dividend from CFC2 during each of the consolidated taxable years ending July 31, 1998, 1999, 2000, 2001, 2002, and 2003 in the amount of \$150x, \$150x, \$200x, \$100x, \$50x, and \$100x, respectively.

(ii) *Result.* USP first determines the base period inclusions of US1 and US2 to determine the consolidated group’s base period inclusions. Pursuant to section 965(c)(2), the base period includes the five most recent taxable years of the USP group that ended on or before June 30, 2003, which are the group’s taxable years ending July 31, 1998 (year 1) through July 31, 2002 (year 5). Accordingly, USP will have base period inclusions as follows:

<sup>4</sup> The terms “consolidated group,” “member,” “subsidiary,” and “separate return year” are defined in Treas. Reg. §1.1502–1. In addition, the term “member” also refers, when the context so requires, to a member of a section 52(a) group.

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*Taxable year ending*

July 31, 1998  
July 31, 1999  
July 31, 2000  
July 31, 2001  
July 31, 2002

*USP group base period inclusions*

\$250x  
\$150x  
\$200x  
\$100x  
\$50x

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To determine its base period years pursuant to section 965(c)(2), USP disregards the taxable years in its base period with the highest and lowest base period inclusions, which are 1998 (\$250x) and 2002 (\$50x). To determine its base period amount, USP then averages the base period inclusions for the remaining three taxable years (that is, the base period years). Therefore, USP's base period amount is \$150x  $((\$150x + \$200x + 100x)/3)$ .

#### *.02 Translation of Previously Taxed Income Distributed During the Base Period*

For purposes of determining the dollar amount of base period inclusions attributable to distributions of PTI described in section 965(b)(2)(B)(iii), distributions of foreign currency are valued by multiplying the distributing CFC's foreign currency amount of the PTI distribution by the spot rate (as defined in Treas. Reg. §1.988-1(d)(1)) on the date of distribution.

### SECTION 4. MAXIMUM AMOUNT ELIGIBLE FOR SECTION 965(a) — GENERAL PRINCIPLES

#### *.01 Applicable Financial Statement*

As noted above, the amount of dividends eligible for the section 965(a) DRD may be limited by section 965(b)(1)(B) or (C) to either: (1) the amount shown on the taxpayer's applicable financial statement as earnings permanently reinvested outside the United States; or (2) in the case of an applicable financial statement that does not show a specific amount of earnings permanently reinvested outside the United States but that does show a specific amount of tax liability attributable to such earnings, the amount of such liability divided by 0.35. Also as noted above, the term "applicable financial statement" means the most recently audited financial statement (including notes and other documents which accompany such statement) which is certified on or before June 30, 2003, as being prepared in accordance with generally accepted accounting principles, and which is used for the purposes of a

statement or report to creditors or shareholders or for any other substantial non-tax purpose. For purposes of determining an amount shown on a taxpayer's applicable financial statement pursuant to section 965(b)(1)(B) or (C), the parenthetical reference to notes and other documents accompanying the statement only includes notes and documents that form an integral part of the financial statement; it does not include work papers or other materials underlying or supporting the statement.

#### *.02 Determination of APB 23 Limitation of a U.S. Shareholder*

For purposes of section 965(b)(1)(B) and (C), the specific amount shown on the applicable financial statement that reflects the amount determined under paragraph 12 of APB 23 (or, in the case of section 965(b)(1)(C), a specific amount of tax liability) and that is disclosed as required under Financial Accounting Standards Board Statement 109, is treated as an amount of earnings permanently reinvested outside the United States (or, the amount of tax liability attributable to such earnings), regardless of the specific language used to describe such specific amount on the applicable financial statement.

#### *.03 Amount of Tax Liability Attributable to Earnings Permanently Reinvested*

If an applicable financial statement fails to show a specific amount of earnings permanently reinvested outside the United States, but instead shows a specific amount of tax liability attributable to such earnings, the APB 23 limitation under section 965(b)(1)(C) is the specific amount of such tax liability divided by 0.35. This amount may not be adjusted (for example, to take into account the foreign taxes imposed on such earnings).

The following example illustrates the application of section 965(b)(1)(C) and this section 4.03.

*Example.* (i) *Facts.* A CFC has earnings permanently reinvested outside the United States that have

been subject to foreign tax of \$10x. The applicable financial statement of the U.S. shareholder that wholly owns such CFC does not show a specific amount of earnings permanently reinvested outside the United States, but instead shows a \$25x tax liability attributable to such earnings.

(ii) *Result.* Although the applicable financial statement of the U.S. shareholder does not show an amount of permanently reinvested earnings, it does show a tax liability of \$25x attributable to earnings permanently reinvested. Thus, the amount described in section 965(b)(1)(C) is \$71.4x  $(\$25x/0.35)$ . This amount may not be adjusted to take into account the foreign taxes imposed on such earnings.

#### *.04 Allocation of APB 23 Limitation*

As noted above, section 965(c)(5)(C) provides that if a financial statement is an applicable financial statement for more than one U.S. shareholder, APB 23 limitation is divided among such shareholders under regulations prescribed by the Secretary. In such a case, the portion of the APB 23 limitation allocated to the U.S. shareholder is the amount from the separate company financial statements (or supporting work papers) of such U.S. shareholder that were prepared in connection with determining the amount described in section 965(b)(1)(B) or (C) shown on the applicable financial statement that included such U.S. shareholder.

Section 965(c)(5)(C) contemplates not only the situation where the financial statement reflects the operations of affiliated corporations that are not consolidated for tax purposes (for example, a U.S. corporation and a domestic subsidiary thereof that elects to apply section 936), but also the situation where the financial statement reflects the operations of corporations that were formerly affiliated and/or consolidated but are not in such relationship during a section 965 election year. See section 6 of this notice for rules regarding the allocation of APB 23 limitation in such a case.

The following example illustrates the application of section 965(b)(1) and this section 4.04.

*Example.* (i) *Facts.* USP is a domestic corporation that files a consolidated return with its

wholly-owned subsidiaries US1 and US2. USP also wholly owns US3, which does not join in the USP consolidated return because an election under section 936 is in effect with respect to US3. US1, US2 and US3 each wholly owns a foreign corporation, CFC1, CFC2, and CFC3, respectively. Even though US3 is not part of the USP consolidated group for U.S. tax purposes, US3 is consolidated with USP, US1, and US2 for financial accounting purposes. On USP's applicable financial statement, USP reported \$350x of earnings permanently reinvested outside the United States. The separate company financial statements of US1, US2, and US3 that were used in preparing the USP applicable financial statement reported earnings permanently reinvested by CFC1, CFC2, and CFC3 to be \$100x, \$50x and \$200x, respectively.

(ii) *Result.* The portion of the USP APB 23 limitation allocated to US1, US2, and US3 is that portion reflected on the separate company financial statements (or supporting work papers) of US1, US2, and US3 that were used in determining the USP APB 23 limitation on its applicable financial statement. Thus, US1 is allocated \$100x, US2 is allocated \$50x, and US3 is allocated \$200x of the \$350x APB 23 limitation. Because US1 and US2 are members of the USP consolidated group and such group is treated as one U.S. shareholder, the USP consolidated group's APB 23 limitation equals \$150x (\$50x + \$100x).

#### .05 Allocation of \$500 Million Limitation

As noted above, section 965(c)(5)(B) provides that all corporations which are included in a section 52(a) group are limited to one \$500 million limitation, which is divided among such corporations under regulations prescribed by the Secretary. Each qualified member of a section 52(a) group is allocated a portion of the section 52(a) group's single \$500 million limitation if it is a qualified member on the last day of the election year of the qualified member with the last election year to end (apportionment date). A "qualified member" is either: (1) a domestic corporation that files a separate tax return and is a member of a section 52(a) group; or (2) a consolidated group that is part of a section 52(a) group. Accordingly, if a consolidated group is not a part of a section 52(a) group, it has its own \$500 million limitation, and, if a consolidated group is part of a section 52(a) group, the portion of the \$500 million allocated to the consolidated group is not further allocated between and among the members of the consolidated group.

The section 52(a) group's single \$500 million limitation is allocated to all qualified members in proportion to the aggregate amount of total current and accumulated earnings and profits that are not previously taxed (non-PTI earnings

and profits) of all CFCs owned (within the meaning of section 958(a)) by such qualified members. For purposes of this rule, a consolidated group is treated as owning CFCs within the meaning of section 958(a), if any member of the group owns CFCs within the meaning of section 958(a). The amount of non-PTI earnings and profits of a CFC owned (within the meaning of section 958(a)) by a qualified member is the sum of the amounts of earnings and profits of such CFC appropriately reported on Schedule J, items 7(a) and 7(b), of the last Form 5471 filed by or on behalf of such qualified member on or before the apportionment date with respect to such CFC, translated into U.S. dollars at the average exchange rate for the CFC's taxable year (see section 989(b)(3)).

The following example illustrates the application of section 965(b)(1) and the rules of this section 4.05.

*Example.* (i) *Facts.* FP, a foreign corporation, wholly owns two domestic corporations, US1 and US2. US1 and US2 each wholly owns a foreign corporation, CFC1 and CFC2, respectively. US1 and US2 each has a taxable year ending July 31, and they each make an election under section 965 for the taxable year ending July 31, 2006. US1 and US2 have APB 23 limitations of zero. On US1's last Form 5471 filed on or before the July 31, 2006 apportionment date with respect to CFC1, US1 reported an amount of non-PTI earnings and profits for CFC1, translated into U.S. dollars using the average exchange rate, of \$100x. On US2's last Form 5471 filed on or before the July 31, 2006 apportionment date with respect to CFC2, US2 reported an amount of non-PTI earnings and profits for CFC2, translated into U.S. dollars using the average exchange rate, of \$300x.

(ii) *Result.* US1 and US2 do not have an APB 23 limitation and, thus, their maximum amount eligible for the section 965(a) DRD is \$500 million. Because US1 and US2 are members of the same section 52(a) group, they are limited to one \$500 million limitation, which is allocated between them. Pursuant to this section 4.05, the \$500 million limitation is allocated in proportion to the aggregate U.S. dollar amount of non-PTI earnings and profits reported on the last Form 5471 filed on or before the apportionment date by US1 and US2 with respect to CFC1 and CFC2, respectively. The apportionment date for the FP group is July 31, 2006. Consequently, US1 is allocated \$125 million of the \$500 million limitation ( $\$100x/\$400x \times \$500$  million) and US2 is allocated \$375 million of the \$500 million limitation ( $\$300x/\$400x \times \$500$  million).

### SECTION 5. TAXABLE YEAR TO WHICH SECTION 965 APPLIES

#### .01 In General

Section 965(f) provides that a taxpayer may elect to apply section 965 to either the

taxpayer's last taxable year beginning before October 22, 2004, or the taxpayer's first taxable year starting during the one-year period beginning on October 22, 2004 (eligible year). Thus, assuming that the other requirements of section 965 are met, a taxpayer may elect to apply the section 965(a) DRD with respect to cash dividends (as defined for purposes of section 965(a)) received by a U.S. shareholder from its CFCs in an eligible year. Except as otherwise provided in this section 5, an eligible year may include a short taxable year.

#### .02 Consolidated Groups

For taxpayers that are members of a consolidated group, the common parent may elect on behalf of all the members to apply section 965 to one of the group's eligible years. The election applies to each member of the group that is included in the group's income tax return for that eligible year, but only for the portion of the eligible year during which such member is a member of the group. Further, every member can receive a cash dividend from a CFC that otherwise qualifies under section 965(a) during any period the recipient is a member of such group. This rule applies even if: (1) as a result of a subsidiary entering or leaving the group, the group's election year is, with respect to the particular subsidiary, neither the taxable year that includes October 22, 2004, nor the subsequent taxable year; or (2) a previous separate return year of the subsidiary also was an election year for the subsidiary. This rule also applies as a result of the acquisition of a consolidated group by an unrelated consolidated group, where the previous separate return year of the acquired group was an election year.

Under the rules of the preceding paragraph, if a subsidiary leaves the group during the group's election year, cash dividends received from the subsidiary's CFCs during its short taxable year that ends within the group's election year are eligible for the group's election. As a result, dividends received by the subsidiary during that initial short taxable year can be eligible for the section 965(a) DRD. Moreover, dividends received by the subsidiary during its next short taxable year as part of an acquiring group may also be eligible for the section 965(a) DRD.

In addition, if the departing subsidiary is not immediately thereafter a subsidiary member of another group, it may treat its next short taxable year as an eligible year and make an election under section 965 for that year, even if that next taxable year is neither the taxable year for that subsidiary that includes October 22, 2004, nor the subsequent taxable year, provided that the two short taxable years together do not exceed twelve months (or an equivalent 52–53 week year).

General consolidated return principles apply to reverse acquisitions as defined in Treas. Reg. §1.1502–75(d)(3), so that the taxable year of the continuing group governs its available eligible years and the terminating group members are subject to the general rules for members leaving and entering groups, with the common parent in effect treated as having become a subsidiary of the continuing group.

### .03 Examples

The following examples illustrate the application of the rules of section 965(f) and this section 5.

*Example 1. Member included in election year of different consolidated groups.* (i) *Facts.* USP is the common parent of a calendar year consolidated group that elects to apply section 965 for its taxable year ending December 31, 2004. US1 is a member of the USP group and a U.S. shareholder. USB is the common parent of an unrelated consolidated group that elects to apply section 965 to its taxable year ending June 30, 2005. A member of the USB group acquires all the stock of US1 on November 15, 2004.

(ii) *Result.* Because US1 is included in the USP group during the USP group's section 965 election year (January 1, 2004, through December 31, 2004), US1's taxable year beginning January 1, 2004, and ending on November 15, 2004 is an election year during which cash dividends received from US1's CFCs may be eligible for the section 965(a) DRD. In addition, because US1 is included in the USB group during the USB group's election year (July 1, 2004 through June 30, 2005), cash dividends from US1's CFCs during US1's taxable year beginning on November 16, 2004 and ending June 30, 2005, may be eligible for the section 965(a) DRD of the USB group.

(iii) *Alternative facts.* If USB instead makes an election under section 965 for its taxable year ending June 30, 2006, cash dividends from US1's CFCs during the USB group's election year may still be eligible for the section 965(a) DRD. In this case, however, that election year is US1's taxable year from July 1, 2005, through June 30, 2006. Section 965 will not apply to US1's year beginning November 16, 2004, and ending June 30, 2005.

*Example 2. Special rule for member departing but not joining a consolidated group.* (i) *Facts.* Assume the same facts as in *Example 1*, except instead

of being acquired by an unrelated consolidated group, the stock of US1 is distributed to the shareholders of USP on November 15, 2004, and US1 becomes the common parent of a new consolidated group which also maintains a taxable year ending December 31.

(ii) *Result.* Because the taxable year ending December 31, 2004, is the USP group's election year, US1's taxable year beginning January 1, 2004, and ending on November 15, 2004, is an election year during which cash dividends received from US1's CFCs may be eligible for the section 965(a) DRD. Further, because US1 ceased to be a member of the USP group during its election year and did not become a subsidiary member of another consolidated group, US1 may make an election under section 965 for the subsequent short taxable year, which begins on November 16, 2004, and ends on December 31, 2004. This election will also apply to the other members of the US1 group during that short taxable year. US1 will not be able to make an election under section 965 for 2005.

*Example 3. Acquisition of target resulting in single short election year.* (i) *Facts.* USP is the common parent of a calendar year consolidated group that elects to apply section 965 for its taxable year ending December 31, 2004. US1 is a member of the USP group and a U.S. shareholder. On November 15, 2004, the stock of US1 is distributed to the shareholders of USP; after such distribution, US1 is not a member of a consolidated group and therefore files a separate return. USB is the common parent of an unrelated consolidated group that plans to apply section 965 to its taxable year ending December 31, 2005. On December 15, 2005, US1 purchases all the stock of USB for cash. US1 and its subsidiaries elect to file a consolidated return for the taxable year ending December 31, 2005.

(ii) *Result.* Because the taxable year ending December 31, 2004, is the USP group's election year, US1's taxable year beginning January 1, 2004, and ending on November 15, 2004, is an election year during which cash dividends received from US1's CFCs may be eligible for the section 965(a) DRD. Further, because US1 ceased to be a member of the USP group during its election year and did not become a subsidiary member of another consolidated group, US1 may make an election under section 965 for its short taxable year that begins on November 16, 2004, and ends on December 31, 2004. However, 2005 is not an eligible year for US1 or its consolidated group. The USB group's final taxable year ends on December 15, 2005, when it is acquired by US1. That short taxable year is an eligible year for which the USB group may make an election under section 965. Thereafter, the members of the former USB group will become members of the US1 group. Because the USB group was acquired after the US1 election year, the former USB group members may not participate in an election under section 965 for any period after December 15, 2005.

*Example 4. Effect of reverse acquisition.* (i) *Facts.* Assume the same facts as in *Example 3*, except that US1's acquisition of USB is for US1 stock rather than cash and the acquisition is a reverse acquisition described in Treas. Reg. §1.1502–75(d)(3).

(ii) *Result.* Under Treas. Reg. §1.1502–75(d)(3)(i), the USB group is treated as continuing to exist after the reverse acquisition with US1 as its common parent. The USB group's taxable year end-

ing December 31, 2005, is an eligible year for which the group may make an election under section 965. This election applies to cash dividends received by US1 after the acquisition when US1 was in the USB consolidated group (the period beginning December 16, 2005, and ending December 31, 2005), as well as to dividends received by the USB group members during the calendar year while USB was the common parent. As in *Example 3*, US1's short taxable year that begins on November 16, 2004 and ending on December 31, 2004, is an eligible year. However, US1's taxable year beginning January 1, 2005, and ending December 15, 2005, is not an eligible year for US1.

*Example 5. Consolidated group included in election year of different consolidated groups.* (i) *Facts.* Assume the same facts as in *Example 1* (i), except that a member of the USB group acquires the USP group on November 15, 2004, and the USP group makes an election under section 965(a) for the taxable year January 1, 2004 through November 15, 2004.

(ii) *Result.* Because the USP group's election year is January 1, 2004 through November 15, 2004, USP's taxable year beginning January 1, 2004, and ending on November 15, 2004, is an election year during which cash dividends received from the USP group's CFCs may be eligible for the section 965(a) DRD. In addition, because USP is included in the USB group during the USB group's election year (July 1, 2004 through June 30, 2005), cash dividends from the USP group's CFCs during USP's taxable year beginning on November 16, 2004 and ending June 30, 2005 may be eligible for the section 965(a) DRD of the USB group. If, in the alternative, USB elects to apply section 965 to its taxable year ending June 30, 2006, cash dividends from the USP consolidated group's CFCs during USP's taxable year beginning July 1, 2005, and ending June 30, 2006, may be eligible for the section 965 DRD of the USB consolidated group.

## SECTION 6. EFFECTS OF CERTAIN TRANSACTIONS ON BASE PERIOD INCLUSIONS AND MAXIMUM AMOUNT ELIGIBLE FOR SECTION 965(a) DRD

### .01 Base Period Inclusions and APB 23 Limitation as U.S. Shareholder Attributes

(a) *In general.* For purposes of section 965, base period inclusions and APB 23 limitation are historical amounts that are treated as tax attributes particular to a U.S. shareholder as of the date these amounts are fixed under section 965(b)(1) and (2). See section 2.01 of this notice for the definition of the term "U.S. shareholder" for this purpose. Consequently, base period inclusions and APB 23 limitation remain with a particular U.S. shareholder (for example, when a U.S. shareholder ceases to be a member of a consolidated group). See *Example 1* of section 6.01(d) of this notice. In addition, base period inclusions

and APB 23 limitation are treated in the same manner as items described in section 381(c). Therefore, if a corporation acquires the assets of a U.S. shareholder in a transaction described in section 381(a), the acquiring corporation succeeds to and takes into account the base period inclusions and APB 23 limitation of the transferor U.S. shareholder under the principles of section 381. See *Example 5* of section 6.01(d) of this notice. For exceptions to these general rules, see section 6.01(b) and (c) of this notice.

Because these amounts are not treated as tax attributes particular to a CFC, they are unaffected by a disposition of a CFC. Thus, these rules apply even if the U.S. shareholder no longer owns the CFC that gave rise to the base period inclusions or APB 23 limitation. Similarly, because these amounts are tax attributes of the U.S. shareholder rather than the CFC, a domestic corporation that acquires the assets of a CFC in a transaction described in section 381(a) does not succeed to and take into account base period inclusions and APB 23 limitation attributable to the transferor CFC under the principles of section 381. See *Example 1* of section 6.01(d) of this notice.

(b) *Adjustments for acquisitions and dispositions of U.S. shareholders that are included in consolidated returns.* (1) *In general.* Members of a consolidated group generally are treated as a single U.S. shareholder for the purpose of determining the group's base period amount or APB 23 limitation. However, when a member exits or enters a U.S. consolidated group, adjustments are required to the selling<sup>5</sup> and/or acquiring group's base period inclusions and APB 23 limitation to reflect that base period inclusions and APB 23 limitation generally remain with a particular U.S. shareholder (that is, with the specific member rather than with the group itself). The selling group reduces its base period inclusions and APB 23 limitation by the amounts that are attributable to a departed member, and the acquiring group correspondingly increases its base period inclusions and APB 23 limitation to account for the new member. For exceptions to these general rules, see paragraph

(2), below, and *Examples 1, 4, 8 and 9* of section 6.01(d) of this notice. For specific rules addressing the determination of base period inclusions, see section 6.01(b)(3) of this notice.

When adjusting a consolidated group's base period inclusions to reflect the entry or exit of a U.S. shareholder, the consolidated group makes the adjustment to the specific base period inclusions (as opposed to the base period amount) for the group to reflect the particular base period inclusions of the acquired or disposed of U.S. shareholder or its successor. In the same way, the consolidated group makes an adjustment to its APB 23 limitation to reflect the APB 23 limitation attributable to the acquired or disposed of U.S. shareholder or its successor.

The rules of this paragraph that apply to dispositions or acquisitions of a member of a consolidated group also apply, as relevant, in the context of the acquisition of an entire consolidated group.

(2) *Special adjustment rules dependent upon timing of certain acquisitions or dispositions of U.S. shareholders.* Certain adjustments to base period inclusions and/or APB 23 limitation provided under paragraph (b)(1) of this section are not made if certain transactions occur during the selling group's election year, or certain transactions occur before or after a selling group's or acquiring group's<sup>6</sup> APB 23 determination date. In addition, special rules are provided in section 6.01(c) of this notice with respect to certain spin-off transactions.

Specifically, under this paragraph (b)(2), when a U.S. shareholder ceases to be a member of a selling group during the selling group's election year, the selling group's base period inclusions and APB 23 limitation are not reduced by amounts attributable to the departing U.S. shareholder. Nonetheless, the acquiring group still increases its base period inclusions and, subject to the special rules of this paragraph (b)(2), its APB 23 limitation attributable to the acquired U.S. shareholder under the general rules of paragraph (b)(1) of this section. See *Example 1* of section 6.01(d) of this notice. In addition, dividends received by the U.S. shareholder

from its CFCs in any other election year may be taken into account in that year for purposes of section 965. See also section 5 of this notice for a discussion of taxable years to which section 965 applies.

This paragraph provides special rules to ensure that an acquiring consolidated group appropriately reflects an APB 23 limitation with respect to an acquired member when: (1) that member ceases to be a member of a selling consolidated group before the selling group's APB 23 determination date; and/or (2) that member joins an acquiring group before the acquiring group's APB 23 determination date. Specifically, if a U.S. shareholder joins a consolidated group before the acquiring group's APB 23 determination date, there is no adjustment to the acquiring group's APB 23 limitation because the U.S. shareholder's membership in the new group (and such U.S. shareholder's ownership of CFCs at the relevant time with permanently reinvested earnings) will be taken into account when determining the acquiring group's APB 23 limitation. Under the preceding sentence, if the selling group's APB 23 determination date has passed, the selling group reduces its APB 23 limitation to account for the departed U.S. shareholder. If a U.S. shareholder ceases to be a member of a consolidated group before the selling group's APB 23 determination date, there is no downward adjustment to the selling group's APB 23 limitation to reflect the departure because the selling group's APB 23 limitation will reflect such disposition. However, if a U.S. shareholder ceases to be a member of a consolidated group before the selling group's APB 23 determination date but after the acquiring group's APB 23 determination date, the acquiring group's APB 23 limitation is increased by the amount of the selling group's APB 23 limitation that would be allocated to the acquired U.S. shareholder under section 4 of this notice if the selling group substituted "the date of the acquisition" for "June 30, 2003" in applying section 965(c)(1).

The rules of this paragraph that apply to dispositions or acquisitions of a member of a consolidated group also apply, as

<sup>5</sup> For purposes of this section 6, the term "selling group" also includes a group in which a U.S. shareholder ceases to be included as a member as a result of transactions other than sales (for example, through the distribution of the stock of the member).

<sup>6</sup> For purposes of section 6, the term "acquiring group" includes a consolidated group that comes into existence after the acquisition of a corporation.

relevant, in the context of the acquisition of an entire consolidated group.

(3) *Determining the base period inclusions to be inherited.* When an acquiring group adjusts its base period inclusions to take into account an acquisition of a U.S. shareholder or consolidated group, the acquiring group takes into account five taxable years in the relevant base period for any acquired shareholder or group, assuming at least five taxable years are available. The inclusions are aggregated for taxable years one through five without regard to whether they are short or full taxable years on either side. An acquired U.S. shareholder or group cannot contribute more than five taxable years of inclusions to the base period history of the acquirer. The fifth taxable year in the acquiring group's base period is the last potential taxable year in its base period.

If the acquired U.S. shareholder or group joins the acquiring group after the end of the acquiring group's base period, the acquired U.S. shareholder's or acquired group's base period inclusions in its last five taxable years ending on or before June 30, 2003, are aggregated with the acquiring group's base period inclusions in its five base period taxable years, on a year-by-year basis.

Similarly, if an acquired U.S. shareholder or group joins the acquiring group before the end of the acquiring group's base period, the acquiring group inherits a base period inclusion history for the acquired U.S. shareholder or group for each of the taxable years in the acquiring group's base period that end on or before the date of the acquisition. The acquired U.S. shareholder's or acquired group's taxable year ending on the date of the acquisition shall correspond to the taxable year in the acquiring group's base period that ends on or before the date of the acquisition. The acquiring group then takes into account base period inclusions from the acquired U.S. shareholder's or group's taxable years prior to the taxable year ending with the date of the acquisition to the extent necessary to assemble a base period inclusion history for the inherited years. An acquired U.S. shareholder or acquired group may contribute five taxable years to the acquiring group's history even if the acquiring group did not itself exist for its full five taxable year base period. For

illustrations of these rules, see *Example 7* and *Example 8* of section 6.01(d).

(c) *Special rules for spin-offs.* (1) *In general.* Except as provided in paragraphs (c)(2) and (3) of this section, a distribution to which section 355 (or so much of section 356 as relates to section 355) applies is treated in the same manner as a disposition of the stock of the controlled corporation (controlled) by the distributing corporation (distributing) for purposes of section 965 and this notice. See sections 5, 6.01(a) and (b) of this notice and *Example 2* of section 6.01(d) of this notice.

(2) *Spin-off of a U.S. shareholder that occurs during the base period — allocation of base period inclusions.* In the case of a spin-off of the stock of a U.S. shareholder to which section 355 (or so much of section 356 that relates to section 355) applies that occurs during the base period, and after which either distributing or controlled is a U.S. shareholder of a CFC (applicable base period spin-off), any base period inclusions received by either distributing or controlled from such CFC are allocated as provided in section 965(c)(2)(C)(ii). For purposes of determining distributing's and controlled's base period inclusions and base period amounts under section 965(c)(2)(C)(ii), section 965(c)(2)(C)(ii)(I) treats controlled as having been in existence for the same period that distributing has been in existence. Further, section 965(c)(2)(C)(ii)(II) allocates base period inclusions that are received or includible by distributing and controlled from a CFC prior to an applicable base period spin-off of controlled based on the fair market values of distributing's and controlled's interests in such CFC immediately after such spin-off.

However, if stock of a member of a consolidated group is distributed pursuant to an applicable base period spin-off and, as a result of such distribution a controlled corporation leaves the consolidated group, the base period inclusions of the consolidated group with respect to each of the group's CFCs before the applicable base period spin-off are instead allocated between the members of the consolidated group that remain in the distributing corporation's group (distributing group) and the members, if any, that leave the group and thereafter file a consolidated return with the controlled corporation (controlled group) in proportion to the fair market

values of the distributing group's and the controlled group's respective interests in each CFC owned by the distributing group and the controlled group immediately after the applicable base period spin-off. The base period inclusions allocated to the distributing group and the controlled group are further allocated amongst the members of such groups in proportion to the fair market value of such members' respective interests in each CFC immediately after the applicable base period spin-off. See paragraph (c)(3) for the treatment of APB 23 limitations as a result of applicable base period spin-offs described in this paragraph (c)(2).

Section 965(c)(2)(C)(ii)(II) does not apply to any distribution that is not an applicable base period spin-off, such as a distribution that occurs after the base period; nor does it apply to allocate inclusions from CFCs with respect to which neither controlled nor distributing is a U.S. shareholder at the time of the spin-off. Instead, the rules of section 6.01(c)(1) of this notice apply to such distributions or inclusions.

(3) *Spin-off of a U.S. shareholder that occurs during the base period — allocation of APB 23 limitation.* If an applicable base period spin-off (as defined in paragraph (c)(2) of this section) occurs with respect to a U.S. shareholder that is not a member of a consolidated group after the APB 23 determination date of either distributing or controlled, the APB 23 limitation of distributing or controlled is adjusted to the extent that distributing's or controlled's APB 23 limitation is attributable to the stock of a CFC that is transferred between distributing and controlled in connection with the spin-off. Consistent with the treatment of base period inclusions, such adjustment is made by allocating the portion of any APB 23 limitation attributable to distributing or controlled with respect to the earnings of a CFC that is transferred between distributing and controlled in proportion to the fair market values of such corporations' respective interests as U.S. shareholders of such CFC immediately after the spin-off. If a spin-off occurs before the APB 23 determination dates of both distributing and controlled, the general rules of section 4 apply. See *Example 3* of section 6.01(d) of this notice.



If the stock of a member of a consolidated group is distributed pursuant to an applicable base period spin-off and, as a result of such distribution a controlled corporation leaves the consolidated group and, the spin-off occurs after the APB 23 determination date of the consolidated group, the APB 23 limitation that is attributable to each CFC owned by the consolidated group before the applicable base period spin-off is, instead, allocated between the distributing group and the controlled group in proportion to the fair market values of the distributing group's and the controlled group's respective interests in each CFC owned by the distributing group and the controlled group immediately after the applicable base period spin-off. The APB 23 limitation allocated to the distributing group and the controlled group is further allocated between and among the members of such groups in proportion to the fair market values of such members' respective interests in each CFC immediately after the applicable base period spin-off.

(d) *Examples.* The following examples illustrate the application of section 965(b)(1) and (2) and this section 6.01. Unless otherwise indicated, the following facts are assumed for purposes of these examples. All corporations and consolidated groups maintain calendar taxable years and were in existence prior to 1997. USP is a domestic corporation and the common parent of the USP consolidated group. USP wholly owns US1 and US2. US1 and US2 are U.S. shareholders and members of the USP consolidated group. US1 and US2 each wholly owns a foreign corporation, CFC1 and CFC2, respectively. USP elects to apply section 965 to its 2005 taxable year. USB is a domestic corporation and the common parent of the USB consolidated group, which is a consolidated group prior to any transactions described below. All domestic corporations acquired by the USB group that are eligible to do so elect to join in filing a consolidated return with the USB group. USB elects to apply section 965 for its 2005 taxable year. No elections are made under section 338 with respect to stock purchases.

*Example 1. Sale of U.S. shareholder by consolidated group.* (i) *Facts.* On December 31, 2003, USP sells the stock of US1 to an unrelated foreign person, FP. US1 files a separate return for the taxable years following such sale. On October 25, 2004, US2 sells CFC2 to USB for cash.

(ii) *Result.* On January 1, 2004, US1 is no longer a member of the USP consolidated group as a result of the sale of the US1 stock to FP. Accordingly, the USP group reduces its base period inclusions and APB 23 limitation attributable to US1. In addition, because US1 files a separate return after it ceases to be a member of the USP consolidated group, it takes into account its individual base period inclusions and APB 23 limitation. In contrast, US2's sale of CFC2 does not affect US2's base period inclusion history or APB 23 limitation, because base period inclusions and APB 23 limitation are not tax attributes of CFCs. Consequently, the USP group does not reduce its base period inclusions or APB 23 limitation as a result of the sale of CFC2. Similarly, USB does not make any adjustment to its base period inclusions or APB 23 limitation as a result of the acquisition of CFC2.

(iii) *Alternative Facts.* Assume the same facts as above, except that USP sells the stock of US1 to FP on February 15, 2005. On February 16, 2005, US1 is no longer a member of the USP consolidated group as a result of the sale of the US1 stock to FP. Because the transaction occurs within the USP election year, the USP group does not reduce its base period inclusions and APB 23 limitation attributable to US1. Further, US1 still takes into account its individual base period inclusions and APB 23 limitation should it make an election with respect to section 965(a) in its short taxable year following the acquisition (February 16, 2005 through December 31, 2005). The result with respect to USB is not changed under the alternative facts.

*Example 2. Spin-off of U.S. shareholder by consolidated group.* (i) *Facts.* The facts are the same as in *Example 1*, except that instead of USP selling the stock of US1, it distributes such stock in a distribution to which section 355 applies. US1 files a separate return for the taxable years following the distribution.

(ii) *Result.* The result is the same as that in *Example 1*. The special rules under section 965(c)(2)(C)(ii) and section 6.01(c)(2) of this notice do not apply because the distribution did not occur during USP's base period (which ended December 31, 2002).

*Example 3. Section 368(a)(1)(D) reorganization/section 355 distribution.* (i) *Facts.* USP owns CFC3. USP has base period inclusions and APB 23 limitation attributable to CFC3. On December 31, 2002, USP transfers the stock of CFC3 to controlled, a newly formed domestic corporation wholly-owned by USP, in a transaction to which section 368(a)(1)(D) applies, and immediately thereafter distributes the stock of controlled in a distribution to which section 355 applies.

(ii) *Result.* The distribution occurs during the USP group's base period and, therefore, the special rules under section 965(c)(2)(C)(ii) and section 6.01(c)(2) and (3) of this notice apply. As a result, USP's base period inclusions and APB 23 limitation that are attributable to CFC3 are allocated as provided in section 965(c)(2)(C)(ii) and section 6.01(c)(2) and (3) of this notice. Therefore, all of the base period inclusions and APB 23 limitation of USP attributable to CFC3 are allocated to controlled because controlled owns all the CFC3 stock immediately after the section 355 distribution.

(iii) *Alternative facts.* The facts are the same as in *Example 3*, except that the transaction occurs on December 31, 2003. Because the distribution does not occur during USP's base period, section

965(c)(2)(C)(ii) and section 6.01(c)(2) and (3) of this notice do not apply. Instead, the general rules of section 6.01(c)(1) of this notice apply. Therefore, none of the base period inclusions, and no portion of the APB 23 limitation, attributable to CFC3 are allocated to controlled; such amounts remain with USP.

*Example 4. Internal spin-off of CFC followed by applicable base period spin-off.* (i) *Facts.* US1 has base period inclusions with respect to CFC1. On June 30, 2002, US1 distributes the stock of CFC1 to USP in a transaction to which section 355 applies (first spin-off). On December 31, 2002, USP transfers the stock of CFC1 to controlled, a newly formed domestic corporation wholly owned by USP, in a transaction to which section 368(a)(1)(D) applies, and immediately thereafter distributes the stock of controlled in a distribution to which section 355 applies (second spin-off).

(ii) *Result.* The first and second spin-offs occur during the USP group's base period. Section 965(c)(2)(C)(ii)(II) does not apply to the first spin-off because CFC1 is not a United States shareholder. As a result US1's base period inclusions attributable to CFC1 are not allocated between US1 and USP in accordance with US1's and USP's proportional ownership of CFC1 after the first spin-off. However, in the second spin-off controlled is distributed out of USP's consolidated group. Accordingly, the USP group's base period inclusions with respect to each of its CFCs before the spin-off of controlled are allocated between the USP group and controlled (or controlled's group if controlled's affiliated group files a consolidated return) in proportion to the USP group's and controlled's (or the controlled group's) interests in each CFC owned by the USP group and controlled (or the controlled group) immediately after the second spin-off.

*Example 5. Merger of a U.S. shareholder and other transactions.* (i) *Facts.* On January 3, 2003, US1 sells its stock in CFC1 to USB for cash. On December 31, 2003, in an unrelated transaction US1 merges into US2. The merger of US1 into US2 is a reorganization under section 368(a)(1)(A). On December 31, 2004, in a transaction unrelated to the merger of US1 into US2, USP sells the shares of US2 to USB for cash. The APB 23 determination date for the USP and USB groups is December 31, 2002.

(ii) *Result.* The sale of CFC1 stock to USB has no effect on the USP group's base period inclusions and APB 23 limitation. The merger of US1 into US2 on December 31, 2003, is a transaction described in section 381(a), and US2 therefore succeeds to and takes into account US1's base period inclusions and APB 23 limitation.

Because US2 ceases to be a member of the USP consolidated group as a result of the sale of its stock to USB, the USP group reduces its base period inclusions and APB 23 limitation attributable to US2, including those amounts US2 succeeds to and takes into account as a result of the merger. Further, because US2 becomes a member of the USB consolidated group on January 1, 2005, USB's base period inclusions and APB 23 limitation are increased by the same amounts by which USP's base period inclusions and APB 23 limitation amount were decreased.

(iii) *Alternative facts.* The facts are the same as *Example 5* (i), except that instead of USP selling the shares of US2 to USB, US2 sells its assets to USB in

exchange for cash (and the assumption of any liabilities of US2) and distributes the cash proceeds to USP pursuant to a liquidation described in section 332.

Under the alternative facts, the result is the same as *Example 5* (ii), except as follows. USP does not make any adjustments to its base period inclusions or APB 23 limitation as a result of the sale of US2's assets to USB because the transaction with USB is not described in section 381(a) (this may not be the case, however, if the assets sold by US2 to USB include stock of a U.S. shareholder that is a member of the USP consolidated group). Further, USP continues to take into account the base period inclusions and APB 23 limitation attributable to US2 after the liquidation of US2 because the liquidation into USP is a transaction described in section 381(a). In addition, the USB consolidated group does not take into account the base period inclusions and APB 23 limitation attributable to US2, because US2 does not become a member of the USB consolidated group (nor does the USB consolidated group acquire the assets of US2 pursuant to a transaction described in section 381(a)).

(iv) *Alternative facts.* The facts are the same as *Example 5* (i), except that USP and USB make an election pursuant to section 338(h)(10) with respect to the sale of the stock of US2. The result under the alternative facts in this paragraph (iv) is the same as under the alternative facts of paragraph (iii) of this *Example 5*. This is the case regardless of whether an election under section 338 is made with respect to the CFC2 stock owned by US2.

*Example 6. Acquisition of U.S. shareholder consolidated group.* (i) *Facts.* USB acquires all the stock of USP on January 3, 2003, a date subsequent to the APB 23 determination dates for both the USP and USB groups. As a result of the acquisition, the USP group terminates and all the members of the USP group become members of USB consolidated group.

(ii) *Result.* USB's acquisition of all the stock of USP causes the USP consolidated group to cease to exist as of the end of January 3, 2003, a date after the end of the base periods of both the USP and USB groups. The USP group's base period inclusions for

each of the five taxable years in its base period is added to the USB group's base period inclusions for each corresponding taxable year in its base period to determine the USB group's base period amount. In addition, because the acquisition occurs after the APB 23 determination dates of both the USB and USP groups, the USB group's APB 23 limitation is increased by the USP group's APB 23 limitation.

*Example 7. Taking into account base period inclusions of acquired U.S. shareholder transferred after the end of the acquirer's base period.* (i) *Facts.* The USB consolidated group uses a taxable year ending March 31. The USB group elects to apply section 965 to its taxable year that begins on April 1, 2005 and ends on March 31, 2006. On May 31, 2005, USB acquires from USP 100% of the stock of US1 for cash.

(ii) *Result.* The acquisition of US1 occurs during the section 965 election year of the USP group and the section 965 election year of the USB group. Therefore, the special rules set forth in section 6.01(b)(2) apply. Under those rules, the USB consolidated group takes into account the base period inclusions of US1 for purposes of determining its base period amount under section 965(b)(2). Because US1 ceases to be a member of the USP consolidated group during the election year of such group, the USP consolidated group will also take into account the base period inclusions of US1 for purposes of determining its base period amount under section 965(b)(2). Accordingly, there is no corresponding decrease by the selling group for the increase by the buying group of base period inclusions and APB 23 amounts as a result of the transaction.

The USB consolidated group's base period includes the five taxable years ending on or before June 30, 2003 (that is, taxable years ending March 31, 1999 through March 31, 2003). Similarly, the base period of US1 and USP includes the five taxable years ending on or before June 30, 2003 (that is, the taxable years ending December 31, 1998 through December 31, 2002).

To determine the USB group's base period amount, US1's base period inclusions for each taxable year in its base period are added to the base

period inclusions for each corresponding taxable year in the USB group's base period. Thus, US1's base period inclusions for its taxable year ending December 31, 2002 are added to the base period inclusions for the USB group's year ended March 31, 2003, and US1's base period inclusions for the other four years in its base period are added to the USB group base period inclusions for the other four corresponding years in the USB group's base period.

Because the acquisition of US1 occurs during the election years of both the USP group and the USB group, both groups will also take into account the APB 23 limitation attributable to US1.

*Example 8. Taking into account base period inclusions of acquired U.S. shareholder transferred before the end of the acquirer's base period.* (i) *Facts.* The facts are the same as *Example 7*, except as follows. USB acquired US1 on February 15, 2002, a date prior to the APB 23 determination dates of both USP and USB. The USB group's base period includes the five taxable years ending March 31, 1999, through March 31, 2003. As a result of its acquisition, the base period of US1 includes its five taxable years that end on the following dates: February 15, 2002; December 31, 2001; December 31, 2000; December 31, 1999; and December 31, 1998.

(ii) *Result.* To determine the USB group's base period amount, US1's base period inclusions for each taxable year in US1's base period are added to the USB group's base period inclusions for each corresponding taxable year in the USB group's base period. US1's short taxable year ending February 15, 2002, corresponds to the last taxable year in the acquirer's base period that ends on or before the date of the acquisition (that is, the USB group's taxable year that ends March 31, 2001). The USB group also succeeds to that portion of US1's base period inclusion history for US1's taxable years that precede the short taxable year ending on February 15, 2002, that correspond to the USB group taxable years in its base period.

The corresponding taxable years in the respective base periods may be illustrated as follows:

<i>US1 base period year-ends</i>	<i>USB group base period year-ends</i>
3/31/03	3/31/03
3/31/02	3/31/02
2/15/02	3/31/01
12/31/01	3/31/00
12/31/00	3/31/99
12/31/99	
12/31/98	

US1's taxable years ending on December 31, 1999, and December 31, 1998, correspond to taxable years of the USB group that precede the USB group's base period. Accordingly, the USB group does not take into account the base period inclusions of US1 in those years. Nevertheless, the USP group will reduce its base period inclusions attributable to US1 for these taxable years.

US1's base period inclusions after February 15, 2002, are naturally taken into account by the USB group in determining its base period inclusions because such inclusions will occur during the time that

US1 is a part of the USB consolidated group. That is, US1 base period inclusions for its taxable year that ends March 31, 2002, and March 31, 2003, are taken into account in determining the USB group's inclusions for such taxable years.

US1 ceased being a member of the USP consolidated group and joined the USB consolidated group before the APB 23 determination dates of both the USP and USB consolidated groups. As a result, no adjustment is made to the APB 23 amount of the USP or USB consolidated groups as a result of the sale of

US1 stock as provided in section 6.01(a)(2) of this notice.

(iii) *Alternative facts.* The facts are the same as in *Example 8*, except that the USB group's first taxable year begins on April 1, 2000. The results are unchanged.

*Example 9. Acquisition of U.S. shareholder stock before Acquirer's but after Seller's APB 23 determination date.* (i) *Facts.* The USP group's applicable financial statement provides for an APB 23 limitation of \$700 million. The limitation is comprised of, as of the APB 23 determination date (December 31,

2002), earnings permanently reinvested in CFC1 of \$400 million and in CFC2 of \$300 million. The \$400 million of CFC1 earnings is attributable to US1, and the \$300 million of CFC2 earnings is attributable to US2. USB maintains a taxable year ending January 31. On January 3, 2003, USP sells to USB 81% of US1's outstanding stock and 60% of the outstanding stock of US2. The USB group's APB determination date is January 31, 2003.

(ii) *Result.* By reason of the transactions, US1 and US2 cease to be members of the USP consolidated group on January 3, 2003, a date that is after the USP group's APB 23 determination date. Therefore, the USP consolidated group reduces its APB 23 limitation by \$700 million because US1 and US2 are no longer members of the USP consolidated group. Similarly, the USP group reduces its base period inclusions to the extent they are attributable to US1 and US2. Further, the acquisition of US1 and US2 occurred prior to USB's APB 23 determination date. Therefore, the USB group does not increase its APB 23 limitation with respect to the transactions because the USB group will take into account permanently reinvested earnings of US1 and US2 for financial accounting purposes on its APB 23 determination date. Finally, USB inherits the relevant base period inclusion history of US1 because US1 joins the USB consolidated group. After the transaction, US2 is not a member of a consolidated group and therefore will file a separate return for subsequent taxable years. If US2 elects to apply section 965 in an eligible year, it will take into account its base period inclusion history and its APB 23 limitation.

(iii) *Alternative facts.* The facts are the same as in *Example 9* (i), except that US1 and US2 are sold on February 1, 2003. The USB group's reported APB 23 limitation is increased by \$400 million as a result of USB's purchase of 81% of the shares of US1 because US1 joins the USB consolidated group after the USB group's APB 23 determination date; it is not increased by the \$300 million attributable to US2 because US2 does not join the USB consolidated group. The base period inclusion results are unchanged.

## .02 Allocated Portion of \$500 Million Limitation

Pursuant to section 4.05 of this notice, the \$500 million limitation described in section 965(b)(1)(A) is allocated among qualified members of a section 52(a) group on a single date, the apportionment date (as defined in section 4.05 of this notice), and only amongst the qualified members of the group on such date. A corporation or consolidated group is not allocated any of the \$500 million limitation and it has a \$0 limitation for an election year during which the corporation or consolidated group was a qualified member of a section 52(a) group if, on or after the end of its election year but before the section 52(a) group's apportionment date (or, if none, the date that would have been the apportionment date had the transaction not occurred), the corporation

or consolidated group becomes unrelated to the other qualified members of the section 52(a) group or ceases to exist.

Once an allocation occurs on an apportionment date, the allocated limit applies to a corporation or consolidated group that is a qualified member of the section 52(a) group for its election years ending while it is a qualified member of such group, including those years that end before the apportionment date. However, if a corporation or consolidated group becomes unrelated to the other qualified members of a section 52(a) group before the end of an election year of such corporation or consolidated group, the corporation or group is entitled to its own \$500 million limitation, unless it becomes part of a different section 52(a) group on or before that group's apportionment date. If it becomes part of a different section 52(a) group on or before that group's apportionment date, it may be allocated a portion of that section 52(a) group's \$500 million limitation. Accordingly, if a corporation or consolidated group is no longer a qualified member of a section 52(a) group, the former member does not retain any of the section 52(a) group's \$500 million limitation after it leaves such group.

The following examples illustrate the application of section 965(b)(1) and this section 6.02. Unless otherwise indicated, it is assumed in each example that all U.S. shareholders have APB 23 limitations of zero.

*Example 1. Disposition of a member which joins an unrelated consolidated group.* (i) *Facts.* A, an individual, wholly owns two domestic corporations, US1 and US2. US1 and US2 in turn each wholly own a foreign corporation, CFC1 and CFC2, respectively. US1 and US2 maintain the calendar year as their taxable year.

On September 30, 2005, A sells US1 to USB. USB is an unrelated domestic corporation and the common parent of a consolidated group that maintains a June 30 taxable year.

US1 elects section 965 for its taxable year ending September 30, 2005. US2 elects section 965 for its taxable year ending December 31, 2005. The USB group elects section 965 for its taxable year ending June 30, 2006.

(ii) *Result.* US2 is entitled to a full \$500 million limitation for its election year ending December 31, 2005, because it is not a member of a section 52(a) group on December 31, 2005. US1 has a limitation of \$0 for its election year ending September 30, 2005, because US1 and US2 would have been members of a section 52(a) group on an apportionment date, December 31, 2005, but for the disposition of US1 on or after the end of US1's election year but before December 31, 2005. The apportioned limitation does

not apply to US1's second election year as a member of the USB group. The USB group has its own \$500 million limitation, which is not adjusted upward as a result of the acquisition of US1.

*Example 2. Disposition of a member which does not join an unrelated consolidated group.* (i) *Facts.* The facts are the same as in *Example 1* except that the buyer of US1 is B, an individual unrelated to A. As in *Example 1*, US1 elects section 965 for its taxable year, which however ends on December 31, 2005.

(ii) *Result.* On December 31, 2005, there is no section 52(a) group, and the election year of neither corporation ended before that date. Therefore, US1 and US2 each has its own \$500 million limitation.

*Example 3. Merger into unrelated corporation.* (i) *Facts.* The facts are the same as in *Example 1* except that instead of the stock of US1 being sold, US1 merges into USB in a reorganization described in section 368(a)(1)(A).

(ii) *Result.* The result is the same as in *Example 1*.

*Example 4. Merger into related corporation.* (i) *Facts.* The facts are the same as in *Example 3* except that US1 merges into US2 in a reorganization described in section 368(a)(1)(A).

(ii) *Result.* US2 is entitled to a full \$500 million limitation for its election year ending December 31, 2005, because it is not a member of a section 52(a) group on December 31, 2005. US1 has a limitation of \$0 for its election year ending September 30, 2005, because US1 and US2 would have been members of a section 52(a) group on their apportionment date, December 31, 2005, but for the merger of US1 which results in the end of US1's election year before December 31, 2005.

*Example 5. Spin-off resulting in unrelated corporation.* (i) *Facts.* USP is a publicly held corporation and the parent of a consolidated group. C and US1 are wholly owned domestic subsidiaries of USP. US1 cannot be included in the USP consolidated group by virtue of section 1504(a)(3) (relating to the five-year period required to elapse before reconsolidation). The USP group and US1 each maintain the calendar year as their taxable years and USP, C, and US1 are each U.S. shareholders of CFCs.

On September 30, 2005, USP distributes the stock of C to its shareholders. Thereafter, USP and C are not members of the same section 52(a) group.

The USP group and US1 each elect section 965 for their taxable years ending December 31, 2005. C also elects section 965 for its short taxable year starting on October 1, 2005, and ending on December 31, 2005.

(ii) *Result.* December 31, 2005, is the apportionment date for the section 52(a) group that consists of the USP group and US1, and the \$500 million limitation is allocated between the USP group and US1 on that date. None of the limitation is allocated to C separately for its short taxable year ending September 30, 2005 (its limitation is \$0), but the apportionment does not apply to C's second election year, the short taxable year ending December 31, 2005. C has its own \$500 million limitation for that second election year.

*Example 6. Spin-off resulting in related corporation.* (i) *Facts.* The facts are the same as in *Example 5* except that all the stock of USP is owned by A, an individual, and A acquires all the stock of C in the

distribution. As a result, USP and C remain members of a single section 52(a) group after the distribution.

(ii) *Result.* December 31, 2005, is the apportionment date for the section 52(a) group that consists of the USP group, US1, and C, and the \$500 million limitation is allocated between the USP group, US1, and C on that date. C's allocation applies to its second election year, the short taxable year ending December 31, 2005. During the time that C is a member of the USP group, it is not separately allocated any of the \$500 million limitation of the section 52(a) group.

*Example 7. Interaction of APB 23 limitation and \$500 million limitation.* (i) *Facts.* The facts are the same as in *Example 1*, except that US1 has an APB 23 limitation of \$300 million, and USB has an APB 23 limitation of \$400 million.

(ii) *Result.* The result is the same as in *Example 1* with respect to the \$500 million limitation. The maximum repatriations allowed under section 965 for US1 in its election year ending September 30, 2005, is the greater of its allocated portion of the \$500 million limitation or its APB 23 limitation. US1's APB 23 limitation of \$300 million exceeds its portion of the \$500 million, which is \$0. Thus, US1's maximum amount under section 965(b)(1) is \$300 million. As in *Example 1*, the USB group's \$500 million limitation is not adjusted as a result of USB's acquisition of US1. However, the USB group's APB 23 limitation is adjusted upward to reflect the \$300 million APB 23 limitation attributable to US1. Because the maximum repatriations allowed under section 965 for the USB group is the greater of \$500 million or APB 23 limitation, the USB group's APB 23 limitation exceeds \$500 million as a result of the acquisition. Thus, USB's maximum amount under section 965(b)(1) is \$700 million (\$400 million + \$300 million).

## SECTION 7. REDUCTION OF BENEFIT FOR INCREASES IN RELATED PARTY INDEBTEDNESS

### .01 Background

(a) *General.* Section 965(b)(3) provides that a U.S. shareholder reduces the amount of dividends otherwise eligible for the deduction under section 965(a) by any increase in the indebtedness of its CFC to any related person (as defined in section 954(d)(3)) between October 3, 2004, and the close of the taxable year for which the election under section 965 is in effect. For purposes of section 965(b)(3), all CFCs with respect to which the taxpayer is a U.S. shareholder are treated as a single CFC.

(b) *Definitions.* For purposes of section 965(b)(3) and this section 7, the following definitions apply:

(i) The term "CFC" means all CFCs with respect to which the taxpayer is a U.S. shareholder, treating such CFCs as a single CFC pursuant to section 965(b)(3).

(ii) The term "individual CFC" is used to refer to a single CFC (for example, to identify a single CFC that is acquired or disposed of by a consolidated group U.S. shareholder).

(iii) The term "U.S. shareholder" as used in this section 7 is defined in section 951(b).

(iv) The term "related person" means a person that is related to a CFC within the meaning of section 954(d)(3).

(v) The term "related party indebtedness" means the amount of indebtedness of a CFC to a related person. However, indebtedness between individual CFCs of a U.S. shareholder is disregarded for purposes of section 965(b)(3).

(vi) The term "initial measurement date" means the close of October 3, 2004 or, if the U.S. shareholder so chooses, an alternative date which is provided as a matter of administrative convenience for taxpayers and the IRS. The alternative date is either: (i) the close of September 30, 2004, if such shareholder used a calendar year or a fiscal year as its taxable year; or (2) the close of the last day of such shareholder's fiscal-year month ending nearest October 3, 2004, if such shareholder used a 52–53 week taxable year. However, the U.S. shareholder uses the same date as its initial measurement date for all purposes of section 965.

(vii) The term "last measurement date" means the close of a U.S. shareholder's taxable year for which an election is in effect.

### .02 Definition of Indebtedness

(a) *In general.* Except as provided in this section, for purposes of section 965(b)(3), "indebtedness" is defined under general Federal income tax principles. Further, the amount of indebtedness of a CFC to any related person pursuant to section 965(b)(3) is not reduced or otherwise offset by indebtedness of any related person to the CFC. Thus, for example, if on the initial measurement date or the last measurement date, there is \$100x of indebtedness of a CFC to its U.S. shareholder, and \$10x of indebtedness from such U.S. shareholder to the CFC, the amount of indebtedness under section 965(b)(3)(A) as of such date is \$100x (and not \$90x).

For purposes of section 965(b)(3), indebtedness of a CFC to a foreign disregarded entity that is owned for Federal tax purposes by a related person is treated as related party indebtedness. Thus, for example, if on the initial measurement date there is \$100x of indebtedness from a CFC to a foreign disregarded entity owned by a U.S. shareholder, which is a related person to the CFC, such amount is indebtedness described in section 965(b)(3)(B).

(b) *Exception for Intercompany Trade Payables.* For purposes of section 965(b)(3), the term "indebtedness" does not include indebtedness arising in the ordinary course of a business from sales, leases, or the rendition of services provided to or for a CFC by a related person, provided that such indebtedness is actually paid within 183 days.

### .03 Determination of Related Party Indebtedness

A U.S. shareholder considers the indebtedness of its CFC to related persons only if the U.S. shareholder is a related person with respect to such CFC. For purposes of determining the related party indebtedness of a CFC pursuant to section 965(b)(3), the relationship between the CFC, its creditors, and any of its U.S. shareholders is determined independently on the initial measurement date and the last measurement date, respectively. For example, if on such date the creditor of the CFC is a related person and a U.S. shareholder is a related person with respect to such CFC, the U.S. shareholder has an amount of indebtedness that is considered under section 965(b)(3) and the rules of this section.

### .04 Amount of Reduction under Section 965(b)(3)

(a) *In General.* Pursuant to section 965(b)(3) and the rules of this section, a U.S. shareholder reduces the amount of cash dividends that would otherwise be taken into account under section 965(a) by the excess (if any) of its last measurement date RPI (as determined under section 7.05(b)) over its initial measurement date RPI (as determined under sections 7.05(a) and 7.05(c)). If two or more U.S. shareholders may otherwise be considered to have an amount that is considered under

section 965(b)(3) attributable to the same CFC indebtedness, such shareholders take into account such indebtedness under the rules of 7.06 of this section.

(b) *Indirect Financing of Cash Dividend by a U.S. Shareholder.* Section 965(b)(3) is intended to prevent a U.S. shareholder from directly or indirectly financing a cash dividend qualifying under section 965(a). In addition to the application of the related party indebtedness rule under section 965(b)(3), general tax law principles such as the substance-over-form doctrine and circular cash-flow principles may apply to various financing structures. However, a related party guarantee of CFC indebtedness is not considered to be an indirect financing of a cash dividend for purposes of section 965(b)(3), provided that the CFC is treated as the obligor on the indebtedness for Federal income tax purposes. See *Plantation Patterns, Inc. v. Comm’r*, 462 F.2d 712 (5<sup>th</sup> Cir. 1972), cert. denied, 409 U.S. 1076 (1972).

#### .05 Amount of Related Party Indebtedness on the Initial Measurement Date and the Last Measurement Date

(a) *Initial Measurement Date RPI — General Rule.* A U.S. shareholder determines the amount of the related party indebtedness of its CFC on the initial measurement date and such amount is the “initial measurement date RPI” of such U.S. shareholder. The amount of the initial measurement date RPI is adjusted pursuant to section 7.05(c) of this notice in certain instances. See *Example 1* of section 7.08 of this notice.

(b) *Last Measurement Date RPI — General Rule.* A U.S. shareholder determines the amount of the related party indebtedness of its CFC on the last measurement date and such amount is the “last measurement date RPI” of such U.S. shareholder. Thus, to the extent that a CFC pays all or a portion of the principal on the related party indebtedness before the last measurement date and does not incur any new related party indebtedness before such date, the U.S. shareholder’s last measurement date RPI will be less than its initial measurement date RPI. See *Examples 4 and 6* of section 7.08 of this notice.

(c) *Special Adjustments to Initial Measurement Date RPI.* A U.S. shareholder

reduces its initial measurement date RPI to the extent the U.S. shareholder’s initial measurement date RPI is attributable to any individual CFC with respect to which such shareholder ceases to be a U.S. shareholder or a related person as the result of a transaction before the last measurement date. However, the prior sentence does not apply to the extent, before or as a result of such transaction, all or a portion of the principal on the indebtedness is paid by the debtor (for example, as a result of the liquidation of an individual CFC).

A domestic corporation that becomes a U.S. shareholder and a related person with respect to an individual CFC after such corporation’s initial measurement date, but before the last day of its election year (or a U.S. shareholder that files a separate return for its short taxable year immediately after a transaction during the same period), and that remains a U.S. shareholder and a related person with respect to such individual CFC on its last measurement date, increases its initial measurement date RPI by the amount of related party indebtedness of such individual CFC immediately after the transaction, excluding any indebtedness arising in connection with or as a result of the transaction (for example, as a result of the incorporation of a branch). See *Examples 3, 4, and 10* of section 7.08 of this notice.

If two or more U.S. shareholders may otherwise be considered to have an amount that is considered under section 965(b)(3) attributable to the same CFC indebtedness, such shareholders take into account such indebtedness under the rules of section 7.06 of this notice.

#### .06 Related Party Indebtedness — Multiple U.S. Shareholders

An increase in a CFC’s related party indebtedness may not reduce the total amount of dividends otherwise eligible for the section 965(a) DRD on anything but a dollar-for-dollar basis. Consequently, if more than one U.S. shareholder is a related person with respect to a CFC, then the effect of the increase in the related party indebtedness of the CFC pursuant to section 965(b)(3) is allocated among and between such U.S. shareholders. For this purpose, such increase is allocated on a dollar-for-dollar basis to cash dividends received by such U.S. shareholders that are

otherwise eligible for the section 965(a) DRD in the order that those dividends are received. If such dividends are received by more than one U.S. shareholder on the same day, each U.S. shareholder takes into account the remaining amount of the increase in related party indebtedness of such CFC based on the relative amount of cash dividends received on such day. The overall reduction in dividends of all U.S. shareholders eligible for the section 965(a) DRD under this rule may not exceed the total increase in related party indebtedness under section 965(b)(3). See *Examples 8 and 9* of section 7.08 of this notice.

#### .07 Translation of Foreign Currency-Denominated Related Party Indebtedness

The initial measurement date RPI and the last measurement date RPI of a U.S. shareholder is determined in U.S. dollars. The amount of any indebtedness on both the initial measurement date and the last measurement date is translated into U.S. dollars using the spot rate (as defined in Treas. Reg. §1.988-1(d)(1)) on the initial measurement date. See *Example 7* of section 7.08 of this notice.

#### .08 Examples

The following examples illustrate the application of section 965(b)(3) and this section 7. Unless otherwise indicated, the following facts are assumed for purposes of these examples. USP, a domestic corporation and the common parent of the USP consolidated group that uses the calendar year as its taxable year, wholly owns US1. US1 is a domestic corporation and a member of the USP consolidated group. US1 wholly owns CFC1, a foreign corporation that owes US1 \$100x at the close of September 30, 2004, evidenced by a note (\$100x note). USP wholly owns CFC2, a foreign corporation with no indebtedness owed to persons described in section 954(d)(3). The USP group chooses September 30, 2004, as its initial measurement date and it elects to apply section 965 to its 2005 calendar year tax year.

*Example 1. Determination of the amount of initial measurement date RPI.* (i) *Facts.* The general facts apply.

(ii) *Result.* US1 and USP are each U.S. shareholders with respect to CFC1 and CFC2 and are considered one U.S. shareholder for purposes of section 965(b)(3). Further, CFC1 and CFC2 are considered

one CFC for purposes of section 965(b)(3). The USP group's CFC (CFC1 and CFC2) has indebtedness of \$100x owed to the USP group (and directly to US1 as a member of that group), a related party. Therefore, the USP group has initial measurement date RPI of \$100x.

*Example 2. Determination of initial and last measurement date RPI when CFC transferred or sold.* (i) *Facts.* On December 31, 2004, US1 sells all the stock of CFC1 and the \$100x note to USB, an unrelated U.S. corporation that is the common parent of a consolidated group. Immediately after the transaction, CFC1 owes \$100x to USB. USB makes an election under section 965 for its calendar year ending December 31, 2005. As of USB's last measurement date, it is a U.S. shareholder and related person with respect to CFC1.

(ii) *Result.* Under section 965(b)(3) all CFCs of a U.S. shareholder are treated as one CFC. Moreover, for purposes of section 965(b)(3), all U.S. shareholders that are members of a consolidated group are considered one U.S. shareholder. Therefore, CFC1 and CFC2 are considered one CFC and US1 and USP are considered one U.S. shareholder (the USP group). Only the relationship between CFC1, CFC2 and the USP group is taken into account for purposes of determining the initial measurement date RPI of the USP group, while only the relationship between CFC1 and USB is taken into account for purposes of determining the last measurement date RPI of the USB group.

As of the initial measurement date the USP group's CFC (CFC1 and CFC2) owes \$100x to related parties. Therefore, under section 7.05(a), and without regard to the disposition of CFC1, the USP group's initial measurement date RPI is \$100x. Under section 7.05(c), however, the USP group reduces its initial measurement date RPI to account for the disposition of CFC1. Therefore, the USP group's initial measurement date RPI is \$0. As of the last measurement date, CFC1 is not related to the USP group. Accordingly, the USP group's last measurement date RPI is \$0.

With respect to the USB group, CFC1 is not related to the USB group on the USB group's initial measurement date. Therefore, the USB group's initial measurement date RPI, without consideration of the acquisition of CFC1 is \$0. Under section 7.05(c), however, the USB group increases its initial measurement date RPI by \$100x, the amount of the CFC1's related party indebtedness immediately after the acquisition. Therefore, the USB group has initial measurement date RPI of \$100x. Further, as of its last measurement date, CFC1 owes USB, a related party, \$100x. Therefore, the USB group's last measurement date RPI is \$100x.

(iii) *Alternative facts.* The facts are the same as in (i), except that USB does not purchase the \$100x note due from CFC1. Under section 7.05(c), the USP group reduces its initial measurement date RPI from \$100x to \$0, to account for the disposition of CFC1 (the same result reached in (ii)). Under section 7.05, the USP group's last measurement date RPI is \$0 (the same result reached in (ii)). Under the alternative facts, however, the USB group does not adjust its initial measurement date RPI to take into account the acquisition of CFC1 because immediately after the acquisition CFC1 will owe an indebtedness to US1, which is not a related person. As a result, the USB group has an initial measurement date RPI of \$0. Fur-

ther, the USB group has a last measurement date RPI of \$0.

(iv) *Alternative facts.* The facts are the same as in (i) except that CFC1 liquidates (whether by reason of an actual liquidation or by reason of an election under Treas. Reg. §301.7701-3) into US1 instead of being sold to USB. Under section 7.05(c), the USP group does not decrease its initial measurement date RPI to account for the liquidation. Consequently, the USP group's initial measurement date RPI is \$100x. Under section 7.05(b), the USP group's last measurement date RPI is \$0.

*Example 3. Determination of initial and last measurement date RPI when a U.S. shareholder is transferred to an unrelated person.* (i) *Facts.* The facts are the same as in *Example 1*, except that on December 31, 2004, all the stock of US1 (and indirectly CFC1), is sold to an unrelated U.S. shareholder, USB. US1 joins the USB consolidated group and USB makes an election under section 965 for the taxable year ending December 31, 2005. As of its last measurement date, USB is a U.S. shareholder and related person with respect to CFC1.

(ii) *Result.* Without regard to the disposition of US1, the USP group's initial measurement date RPI is \$100x. Under section 7.05(c), the USP group's initial measurement date RPI is decreased by \$100x, resulting in the USP group having initial measurement date RPI of \$0.

USP computes its last measurement date RPI under section 7.05(b) of this notice. As of the last measurement date, CFC1 owes an indebtedness to US1, a party that is not related within the meaning of section 954(d)(3) to USP. Therefore, the USP group's last measurement date RPI is \$0.

Without regard to the acquisition of US1, the USB group's initial measurement date RPI is \$0. However, under section 7.05(c), the USB group increases its initial measurement date RPI by \$100x, the amount of the related party indebtedness of its CFC (CFC1) immediately after the transaction. Further, the USB group's last measurement date RPI is \$100x because as of its last measurement date, CFC1 owed \$100x to US1, a related person.

(iii) *Alternative facts.* Assume that the stock of US1 is sold to USB on March 31, 2005, which is during the USP group's and the USB group's election year. The results are the same as set forth in (ii), above.

*Example 4. Determination of initial and last measurement date RPI when a new CFC is formed.* (i) *Facts.* The facts are the same as in *Example 1*, except that USP incorporates CFC2 on November 1, 2004, and during the USP election year USP acquires all the stock of USB (and indirectly all of USB's individual CFCs), an unrelated U.S. shareholder. Further, USB is a member of the USP consolidated group on the last day of the USP election year. In part, CFC2 is capitalized with \$100x of related party indebtedness and USP is a U.S. shareholder and a related person with respect to CFC2 on its last measurement date. USB has initial measurement date RPI of \$400x, attributable to its CFCs. Immediately after the acquisition, USB's CFCs continue to have indebtedness owed to USB in the amount of \$400x.

(ii) *Result.* Without regard to the acquisition of USB or the formation of CFC2, under section 7.05(a), the USP group has initial measurement date RPI of \$100x. Under section 7.05(c), the USP group in-

creases its initial measurement date RPI by the related party indebtedness of the USB CFCs immediately after the transaction. Note, however, that no adjustment is made to the USP group's initial measurement date RPI to account for CFC2's related party indebtedness under section 7.05(c). Thus, after adjustment, the USP group's initial measurement date RPI is \$500x. Under section 7.05(b), the USP group's last measurement date RPI is \$600x, which includes the indebtedness of CFC1 (\$100x), CFC2 (\$100x), and the acquired CFCs of USB (\$400x).

(iii) *Alternative facts.* The facts are the same as in *Example 6* (i), except that CFC1 pays US1 \$70x of the \$100x indebtedness on November 1, 2005. The USP group's initial measurement date RPI is \$500, the same as in (ii). Under section 7.05(b), the USP group's last measurement date RPI is \$530x, which includes the indebtedness of CFC1 (\$30x), CFC2 (\$100x), and the acquired CFCs of USB (\$400x). Under section 7.04 of this notice and section 965(b)(3), USP group reduces its dividends otherwise eligible for the section 965(a) DRD by \$30x.

*Example 5. Determination of initial and last measurement date RPI when a U.S. shareholder and its CFC are transferred but the note due from the CFC is left behind.* (i) *Facts.* The facts are the same as in *Example 1*, except that all the stock of US1 (and indirectly CFC1) is sold to an unrelated U.S. shareholder, USB, on December 31, 2004, before USP group's election year ending December 31, 2005. Assume that CFC1's related party indebtedness on the initial measurement date (\$100x) was the result of the indebtedness being owed to USP instead of US1. US1 is a member of the USB group on the USB group's last measurement date.

(ii) *Result.* Without regard to acquisitions and dispositions, the USP group has initial measurement date RPI of \$100x. Because USP was a U.S. shareholder and a related person with respect to CFC1 on the USP group's initial measurement date, but is not a U.S. shareholder or a related person on its last measurement date, section 7.05(c) requires the USP group to reduce its initial measurement date RPI from \$100x to \$0.

On the USP group's last measurement date, CFC1 is not a related person. Therefore, the USP group's last measurement date RPI is \$0.

USB has initial measurement date RPI of \$0, without regard to the acquisition of US1 (and CFC1). No adjustment is made to this amount under section 7.05(c) because immediately after the acquisition CFC1 owed an indebtedness to USP, an unrelated party. Further, the USB group's last measurement date RPI is \$0 because its CFC (CFC1) does not have an indebtedness to a related party on the last measurement date.

*Example 6. Determination of initial and last measurement date RPI when a U.S. shareholder is transferred without the debtor CFC.* (i) *Facts.* The facts are the same as in *Example 1*, except that on December 31, 2004, before the USP group's election year, US1 distributed CFC1 to USP, and then US1 was sold to USB. In addition, CFC1's related party indebtedness on the USP group's initial measurement date was owed to USP instead of US1. Finally, USB has initial measurement date RPI of \$0.

(ii) *Result.* Without regard to the distribution of CFC1 or the disposition of US1, the USP group

has initial measurement date RPI of \$100x. No adjustment is made under section 7.05(c) to the USP group's initial measurement date RPI as a result of the distribution of CFC1 because after the distribution the USP group is a U.S. shareholder and related person with respect to CFC1. Further, under section 7.05(c), the sale of US1 does not require the USP group to reduce its initial measurement date RPI because after the disposition USP is still a U.S. shareholder and related person with respect to CFC1. Therefore, USP has initial measurement date RPI of \$100x. The USP group's last measurement date RPI is also \$100x because on the last measurement date CFC1's indebtedness is owed to USP, a related party.

USB acquires US1, but US1 has no CFCs when it enters the USB consolidated group. Therefore, under section 7.05(c), the USB consolidated group does not increase its initial measurement date RPI. In addition, USB's last measurement date RPI is \$0.

(iii) *Alternative facts.* The facts are the same as in (i), except that the CFC1 indebtedness is owed to US1. Under the alternative facts, the USP group would still have initial measurement date RPI in the amount of \$100x. No adjustment is made to this amount under section 7.05(c) because on the USP group's initial measurement date and last measurement date the USP group was a U.S. shareholder and a related person with respect to CFC1. However, as of the last measurement date, CFC1 will owe an indebtedness to US1, an unrelated party. Therefore, the USP group's last measurement date RPI is \$0. The results with respect to the USB group are the same as set forth in (ii).

*Example 7. Translating RPI denominated in a non-U.S. dollar currency.* (i) *Facts.* CFC1's indebtedness to US1 is denominated in currency u. As of the close of September 30, 2004 (the initial measurement date), CFC1 owed 100u to US1. As of the close of December 31, 2005, CFC1 continued to owe 100u to US1. As of September 30, 2004, the spot rate is 1u/\$1. As of December 31, 2005, the spot rate is 1u/\$1.5.

(ii) *Result.* Pursuant to section 7.05 of this notice, the indebtedness of CFC1 to US1 on the initial measurement date and the last measurement date is converted into U.S. dollars on the spot rate on the initial measurement date. As a result, the indebtedness of CFC1 to US1 on both dates is \$100x.

*Example 8. U.S. shareholder not related to CFC* (i) *Facts.* FP, a foreign corporation, wholly owns US1, a domestic corporation. US1 owns 60% of CFC. US2, a domestic corporation that is unrelated to FP or US1, owns the remaining 40% of CFC. As of the initial measurement date of US1 and US2, CFC has related party indebtedness in the amount of \$100x that is owed to FP.

(ii) *Result.* US1 is a related person with respect to CFC on its initial measurement date. As a result, US1 takes into account the related party indebtedness of CFC for purposes of section 965(b)(3). Because US2 is not a related person with respect to CFC, the \$100x of related party indebtedness is not taken into account by US2 for purposes of section 965(b)(3).

*Example 9. Application of Section 965(b)(3) reduction to multiple U.S. shareholders* (i) *Facts.* USP is a domestic corporation and the common parent of a consolidated group. USP wholly owns US1, a domestic corporation that is not a member of the USP group because an election under section 936 is in ef-

fect with respect to US1. USP and US1 wholly own CFC1 and CFC2, respectively. The USP group and US1 both maintain a calendar taxable year and elect to apply section 965 to the taxable year ending December 31, 2005. USP receives a cash dividend of \$200x from CFC1 on February 1, 2005. US1 receives a cash dividend from CFC2 of \$300x on March 1, 2005. Both cash dividends received by USP and US1 during 2005 are otherwise eligible for the deduction under section 965(a). There is a \$300x increase in CFC1's related party indebtedness pursuant to section 965(b)(3). CFC2 does not have related party indebtedness at any time.

(ii) *Result.* Under section 965(d)(3), the USP group and US1 are both U.S. shareholders and related persons with respect to CFC1. Thus, both the USP group and US1 are required to take into account CFC1's increase in related party indebtedness. Based upon the rules set forth in section 7.06, above, CFC1's \$300x increase in related party indebtedness reduces the amount of the USP group's and US1's dividends eligible for the deduction under section 965(a) based on the earliest cash dividends eligible for the section 965(a) DRD received by the USP group and US1 during the election year. As a result, the USP group takes into account \$200x of the \$300x increase in RPI because it received a cash dividend of \$200x on February 1, 2005. US1 takes into account the remaining \$100x of such increase because it received its cash dividend on March 1, 2005.

(iii) *Alternative Facts.* The facts are the same as *Example 2*, except that USP and US1 received the cash dividends from CFC1 and CFC2, respectively, on the same day during the election year. Under section 7.06, the USP group and US1 take into account the \$300x increase in RPI attributable to CFC1 in proportion to their receipt of cash dividends on such date. Thus, the USP group takes into account \$120x of the increase  $((\$200x/(\$200x + \$300x)) \times \$300x)$ . US1 takes into account the remaining \$180x of the increase  $((\$300x/(\$200x + \$300x)) \times \$300x)$ .

*Example 10. Determination of initial and last measurement date RPI when related party indebtedness arises in connection with or as a result of a transaction.* (i) *Facts.* The facts are the same as in *Example 3*, except that in connection with or as a result of USB's purchase of the stock of US1 (and indirectly CFC1), US1 lends CFC1 \$50x.

(ii) *Result.* With respect to the USP group, the initial measurement date RPI and the last measurement date RPI are the same as in *Example 3*. The USB group's initial measurement date RPI and last measurement RPI are affected. Without regard to the acquisition of US1, the USB group's initial measurement date RPI is \$0. However, under section 7.05(c), the USB group increases its initial measurement date RPI by \$100x, the amount of the related party indebtedness of its CFC (CFC1) immediately after the transaction, but excluding the indebtedness arising in connection with, or as a result of, the transaction. The USB group's last measurement date RPI, however, is \$150x because as of its last measurement date, CFC1 owes \$150x to US1, a related person. Therefore, under section 7.04 of this notice and section 965(b)(3), the USB group reduces its dividends otherwise eligible for the section 965(a) DRD by \$50x.

## SECTION 8. EFFECT OF CERTAIN TRANSACTIONS ON DOMESTIC REINVESTMENT PLANS

### .01 In General

This section addresses the effect of certain transactions on domestic reinvestment plans adopted pursuant to section 965(b)(4) and Notice 2005-10. Section 8.02 of this notice addresses the effect of members entering and exiting a consolidated group. Section 8.03 addresses the effect of certain asset acquisitions. Section 8.04 then provides rules that apply to a corporation that may make permitted investments pursuant to more than one domestic reinvestment plan. Finally, section 8.05 of this notice provides reporting and administrative requirements for transactions addressed by this section 8.

### .02 Members Entering and Exiting a Consolidated Group

A consolidated group may rely on any domestic corporation (regardless of whether such corporation is a U.S. shareholder) to fulfill the group's obligations to make permitted investments under a domestic reinvestment plan if that corporation is a member of the group at any time on or after the first day of the group's election year. For example, if a consolidated group adopts a domestic reinvestment plan and a member leaves the group during or after the group's election year, the group may rely on the former member's subsequent domestic investment activity to satisfy the group's obligations under its domestic reinvestment plan. Similarly, if a domestic corporation joins a consolidated group during or after the first day of the group's election year, the group may rely on the new member's domestic investment activity after it joins the group to satisfy the group's obligations under its domestic reinvestment plan. The rules of this paragraph apply regardless of the amount of cash or property held by the former member or new member at the time it leaves or joins the consolidated group, as the case may be.

In addition, a domestic corporation may rely on any other domestic corporation (regardless of whether such corporation is a U.S. shareholder) to fulfill its obligations to make permitted investments under a domestic reinvestment plan if both corpora-



tions are members of the same consolidated group at the time the investment is made, even if they were not members of the same consolidated group during the corporation's election year. For example, if a corporation adopts a domestic reinvestment plan and the corporation joins a consolidated group after the end of the corporation's election year, the acquired corporation may rely on the subsequent domestic investment activity of any member of the acquiring consolidated group to satisfy the corporation's obligations under its domestic reinvestment plan. Similarly, if a consolidated group adopts a domestic reinvestment plan and the group is acquired by another consolidated group after the acquired group's election year, the acquired group may rely on the subsequent domestic investment activity of any member of its new consolidated group to satisfy the acquired group's obligations under its domestic reinvestment plan.

### .03 Asset Acquisitions

In general, if a corporation acquires assets of another corporation, the acquiring corporation will not succeed to the obligations of the transferor corporation under a domestic reinvestment plan, and investments made by the acquiring corporation therefore are not eligible to satisfy such domestic reinvestment plan. However, if the corporation acquires the assets of a transferor corporation in a transaction described in section 381(a), subsequent investments made by the acquiring corporation (or by members of the acquiring corporation's consolidated group) therefore may be eligible to satisfy the transferor's domestic reinvestment plan.

If, prior to the transaction described in section 381(a), the acquiring corporation was also required or permitted to make permitted investments in order to satisfy a domestic reinvestment plan, the acquiring corporation will continue to be required or permitted to satisfy obligations under that domestic reinvestment plan in addition to any obligations under the transferor's domestic reinvestment plan.

### .04 Designation of Permitted Investment Activity

A single corporation may be able to make permitted investments in satisfaction of more than one domestic reinvestment

plan. However, the same expenditure of funds may not satisfy the investment requirement of more than one domestic reinvestment plan. For example, a single \$100x investment made by an acquired domestic corporation cannot be counted toward the investment requirements of both the selling consolidated group and the acquiring consolidated group. If a permitted investment by a corporation would satisfy the investment requirement of more than one domestic reinvestment plan, the corporation may designate which plan is being satisfied. If a corporation fails to so designate, its domestic investment activities will be treated as fulfilling domestic reinvestment plan obligations in the following order: first, under any plan adopted with respect to its own earliest election year; second, under any plan adopted with respect to its own subsequent election years, if any; and third, with respect to any plan adopted with respect to any other corporation (for example, a transferor in a transaction described in section 381(a) or a consolidated group the corporation later joined) in the order the corporation became required or permitted to make investments in satisfaction of such plan.

### .05 Reporting and Other Administration Requirements under Section 8 of Notice 2005-10

If a former member of a consolidated group contributes to the completion of the group's domestic reinvestment plan (in whole or in part), the obligation to comply with the reporting and other administrative requirements contained in section 8 of Notice 2005-10 will remain with the group if such group continues to exist, or otherwise with the common parent (or successor agent) for the election year, or the common parent of any consolidated group that includes such former common parent (or successor agent).

### .06 Examples

The following examples illustrate the application of section 965(b)(4) and this section 8. Unless otherwise indicated, the following facts are assumed for purposes of these examples: USP is a domestic corporation and the common parent of a consolidated group that uses the calendar year as its taxable year. USP wholly owns

US1 and US2, which are domestic corporations and members of the USP consolidated group. US1 and US2 each wholly owns a foreign corporation, CFC1 and CFC2, respectively. The USP group elects to apply section 965 for its taxable year ending December 31, 2005. The domestic reinvestment plan approved pursuant to section 965(b)(4) and Notice 2005-10 on behalf of the USP group requires that an amount of cash equal to the \$100x cash dividends that are received from the USP group's CFCs will be invested in the United States to fund research and development activities (performed in the United States) of the USP group over a two-year period. On December 31, 2005, CFC1 and CFC2 each distributes \$50x of dividends that are eligible for the section 965(a) DRD.

*Example 1. Member exiting a consolidated group.* (i) *Facts.* On July 1, 2006, all of the stock of US2 is acquired for cash by USB, a domestic corporation and the common parent of the USB consolidated group. Any permitted investments required to be made by the USB group under any domestic reinvestment plan (other than that of the USP group) are made prior to June 30, 2006. Between July 1, 2006 and December 31, 2007, US2 funds \$100x of research and development activities.

(ii) *Result.* Because US2 is a member of the USP group after the beginning of the USP group's election year, US2's funding of \$100x of research and development activities made while it is a member of the USB group will satisfy the USP group's obligations to make such permitted investments specified under the USP group's domestic reinvestment plan. However, the USP group satisfies the reporting and administrative requirements contained in section 8 of Notice 2005-10 with respect to such investment.

*Example 2. Member entering a consolidated group.* (i) *Facts.* On March 31, 2006, USP acquires for cash all the stock of US3, a domestic corporation that is not a member of a consolidated group. US3 elected to apply section 965 to its taxable year ending December 31, 2005. US3's domestic reinvestment plan requires that US3 expend \$5x to compensate existing employees for services performed in the United States over a two-year period. Between April 1, 2006 and December 31, 2007, US3 funds \$100x of research and development activities. During the same period, US2 expends \$5x to compensate existing employees for services performed in the United States.

(ii) *Result.* Because US3 is a member of the USP group after the beginning of the USP group's election year, US3's funding of \$100x of research and development activities after joining the group will satisfy the USP group's obligations to make such specified permitted investments under the USP group's plan. In addition, because US2 is a member of the same consolidated group as US3 when it expends \$5 to compensate existing employees for services performed in the United States (a permitted investment pursuant to section 965(b)(4) and Notice 2005-10),



US3 may rely on US2's expenditure to satisfy its obligation specified under its plan. USP is required to satisfy the administrative requirements with respect to investments under US3's plan.

*Example 3. Asset acquisition of U.S. shareholder.*

(i) *Facts.* The facts are the same as in *Example 2*, except that instead of USP acquiring the stock of US3, US3 merges into US2 in a reorganization under section 368(a)(1)(A) and (a)(2)(D) on March 31, 2006, after which US2 remains a member of the USP group. Between April 1, 2006 and December 31, 2007, US2 funds \$100x of research and development activities and pays \$5x to compensate existing employees for services performed in the United States.

(ii) *Result.* Because US2 acquired the assets of US3 in a transaction to which section 381(a) applies, US2 succeeded to US3's domestic reinvestment plan obligations. US2's payment of \$5x to compensate existing employees for services performed in the United States satisfies its obligation to make a permitted investment specified under US3's plan. The USP group may also rely on US2's funding of \$100x of research and development activities to satisfy the USP group's plan obligations. The result would be the same if, after the merger of US3 into US2, US1, instead of US2, paid \$5x to compensate existing employees for services performed in the United States, because US1 is a member of the same consolidated group as US2 and the compensation is a permitted investment pursuant to section 965(b)(4) and Notice 2005-10.

*Example 4. Failure to designate sufficient investment activity to fulfill multiple domestic reinvestment plans.*

(i) *Facts.* The facts are the same as in *Example 2*, except that US3's plan also required US3 to expend \$5x to fund research and development activities over a two-year period. The USP group fails to designate specific investment activities for purposes of section 8.04 of this notice to satisfy either the USP group domestic reinvestment plan or the US3 domestic reinvestment plan. Between March 31, 2006 and December 31, 2007, US3 funds \$5x of research and development activities and US2 funds \$95x of research and development activities.

(ii) *Result.* Because the USP group failed to designate specific investment activities to satisfy US3's and the USP group's domestic reinvestment plans, US3's permitted investments will first be taken into account under the US3 plan, and US2's permitted investments will first be taken into account under the USP group plan. Consequently, US3's \$5x expenditure will satisfy the US3 plan and cannot be taken into account by the USP group to satisfy its obligation to conduct \$100x of research and development activities. As a result, the USP group will have conducted only \$95x of research and development activities and the USP group's 2005 qualifying dividend is reduced by \$5x. If instead, US3 had merged into US2 on March 31, 2006, as in *Example 3*, and US2 spent the \$100x without designating, all \$100x would have satisfied the USP domestic reinvestment plan. In addition, the US3 plan would fail to have been satisfied, resulting in a \$5x reduction in US3's qualifying dividends.

## SECTION 9. OTHER GUIDANCE

### .01 Section 78 Gross-Up, Disallowance of Expenses Pursuant to Section 965(d)(2),

### *and Computation of Alternative Minimum Tax in Election Year*

Section 78 does not apply to any tax which is not allowable as a credit under section 901 by reason of section 965(d).

The disallowance of expenses in section 965(d)(2) applies only to expenses that are "directly allocable" to the deductible portion described in section 965(d)(1).

For purposes of calculating alternative minimum tax for the election year under section 55(a) in accordance with section 965(e)(1)(B), the taxpayer's regular tax described in section 55(c) and tentative minimum tax determined under section 55(b)(1)(B) do not include tax attributable to nondeductible CFC dividends.

The IRS and Treasury will incorporate the rules in this section 9.01 into subsequent guidance. This subsequent guidance will provide detail regarding these and related rules.

### .02 Contiguous Country Branches of Domestic Life Insurance Companies

Amounts added to the life insurance company taxable income of a domestic life insurance company by reason of section 814(e)(2) (dealing with contiguous country branches of a domestic life insurance company) are not eligible for the section 965(a) DRD.

### .03 Cash Dividends in Excess of Amounts Covered by Domestic Reinvestment Plans

A domestic reinvestment plan may provide for the investment in the United States of an amount that is less than the entire amount of cash dividends that are otherwise eligible for the section 965(a) DRD. In such a case, the section 965(a) DRD applies only to the amount of eligible dividends that are reinvested pursuant to the plan (assuming that all the other requirements under section 965 are satisfied).

### .04 Section 958(a) Chain of Ownership — Stock Deemed Issued Pursuant to Section 304(a)(1)

If stock of an acquiring CFC is deemed to be issued to another CFC pursuant to section 304(a)(1), the acquiring CFC is treated as being in a chain of ownership described in section 958(a) for purposes of applying section 965(a)(2).

The following example illustrates the application of section 965(a)(2) and this section 9.04:

*Example.* (i) *Facts.* USP, a domestic corporation, wholly owns two foreign corporations, CFC1 and CFC2. CFC1 wholly owns a foreign corporation, CFC3. CFC2 has \$100x of current and accumulated earnings and profits described in sections 304(b)(5)(A) and 959(c)(3). During USP's section 965 election year, CFC1 sells all its CFC3 stock to CFC2 for \$100x. Also during USP's election year, CFC1 distributes \$100x to USP that is excluded from gross income under section 959(a).

(ii) *Result.* Because CFC1 is in control of both CFC3 and CFC2 and receives property from CFC2 in exchange for its CFC3 stock, CFC1's sale of CFC3 stock to CFC2 is subject to section 304(a)(1). Accordingly, CFC1 is treated as receiving \$100x as a distribution in redemption of CFC2 stock. Because CFC1 actually owns 100% of CFC3 before the sale and is treated as owning 100% of CFC3 after the sale, pursuant to section 302(d), section 302(a) does not apply to the deemed redemption distribution and the proceeds of the deemed redemption are treated as a distribution to which section 301 applies. Therefore, CFC1 is treated as transferring its CFC3 stock to CFC2 in exchange for CFC2 stock in a transaction to which section 351(a) applies. The CFC2 stock CFC1 is treated as receiving in the deemed section 351 exchange is then treated as redeemed by CFC2 for \$100x. Under section 302, that redemption is treated as a distribution to which section 301 applies because CFC1 owns directly 100% of CFC3 before the redemption of the CFC2 stock that was deemed issued and is treated as owning 100% of CFC3 after the redemption. The deemed redemption proceeds are treated as a distribution to which section 301 applies, and CFC1 is treated as receiving a dividend of \$100x from the current and accumulated earnings and profits of CFC2. For purposes of section 965(a)(2), because CFC1 is treated under section 304(a)(1) as receiving CFC2 stock in the deemed section 351 exchange, CFC1 is treated as receiving the \$100x dividend from another CFC that is in a chain of ownership described in section 958(a).

### .05 Acquisitions of Interests in Business Entities — Modification of Section 5.06 of Notice 2005-10

Section 5.06 of Notice 2005-10 provides, in part, that in valuing assets with respect to certain acquisitions of interests in business entities, the taxpayer must use the same methodology that it uses, under section 864(e) and Treas. Reg. §1.861-9T(g) (that is, tax book value, alternative tax book value, or fair market value), for purposes of allocating and apportioning its interest expense for the taxable year. Notwithstanding that section of Notice 2005-10, the Treasury Department and the IRS have decided that taxpayers may elect to use the fair market value methodology under Treas. Reg. §1.861-9T(g)

for purposes of valuing assets pursuant to section 5.06 of Notice 2005–10, even if they use the tax book value or alternative tax book value methodology for purposes of allocating and apportioning interest expense under section 864(e). Such election is made on the annual report (required under section 8.02(a) of Notice 2005–10) filed by the taxpayer for the taxable year of the acquisition.

#### *.06 Distributions to Intermediary Disregarded Entities — Clarification of Section 3.02 of Notice 2005–10*

Section 3.02 of Notice 2005–10 provides that for purposes of section 965(a), a cash dividend paid by a CFC to a pass-through entity that is owned by a U.S. shareholder is treated as received by such U.S. shareholder only if and to the extent that such shareholder receives cash in the amount of the CFC dividend during the taxable year for which such election is in effect. For this purpose, a disregarded entity need not actually distribute cash to a U.S. shareholder of the CFC, provided that the U.S. shareholder otherwise receives the cash from the disregarded entity and there is no legal obligation for the U.S. shareholder to repay the cash to the disregarded entity.<sup>7</sup> For purposes of the preceding sentence, the term U.S. shareholder is defined in section 951(b).

*Example.* (i) *Facts.* USP, a domestic corporation, wholly owns DE, a disregarded entity. DE wholly owns CFC, a foreign corporation. Since Year 1, USP has held a \$200x obligation of DE. CFC pays a \$100x dividend to DE during Year 3, USP's election year. Also during Year 3, DE repays \$100x of its obligation to USP.

(ii) *Result.* The \$100x dividend paid by CFC is paid to DE, a pass-through entity that is owned by USP. As a result, pursuant to section 3.02 of Notice 2005–10, such dividend is treated as a cash dividend for purposes of section 965 only if and to the extent that USP receives \$100x from DE during Year 3 without an obligation to repay those funds to DE. DE's repayment of \$100x of its \$200x obligation held by USP satisfies this requirement, and the \$100x dividend paid by CFC during the election year therefore qualifies as a cash dividend for purposes of section 965. The result is the same regardless of whether the \$100x repayment by DE is of principal, accrued interest, or both.

(iii) *Alternative Facts.* The facts are the same except that instead of using the \$100x to satisfy a portion of an obligation held by USP, DE uses the \$100x cash to acquire an asset from USP. The result is the same.

## SECTION 10. REPORTING AND OTHER ADMINISTRATIVE REQUIREMENTS

Pursuant to section 6001, the taxpayer must prepare, maintain, and, upon a request by the Commissioner, make available within 30 days of such request, a general description of any transaction that results in: (1) an adjustment to base period inclusions or APB 23 amounts pursuant to section 6 of this notice; (2) an adjustment to initial measurement date RPI pursuant to section 7 of this notice; or (3) a permitted investment being made by a U.S. shareholder that, at the time of such investment, is not a member of the consolidated group that adopted the domestic reinvestment plan pursuant to which such investment is made, as provided under section 8 of this notice. The description must include, as applicable, the name, address, and tax identification number (if available), of all parties relevant to the transaction (for example, selling group, departing or joining member, and acquiring group). In addition, it must include all relevant dates and the amount of adjustments resulting from the transactions.

In addition, pursuant to section 6001, the taxpayer must prepare, maintain, and, upon a request by the Commissioner, make available within 30 days of such request: (1) a list of investments that may satisfy more than one domestic reinvestment plan and the taxpayer designation of which plan the investment satisfies; and (2) those domestic corporations that have participated in more than one election year.

In the case of an adjustment to base period inclusions pursuant to section 6 of this notice, such adjustments may be determined by reference to the separate Form 1120 prepared for the departing U.S. shareholder for the base period years in question, without regard to the fact that the separate Form 1120 does not constitute a processed return, and was prepared to determine the consolidated return of the group of which it was a member.

## SECTION 11. TRANSITION RULES

### *.01 Domestic Reinvestment Plans Approved Prior to May 10, 2005*

If a domestic reinvestment plan is approved prior to May 10, 2005, the taxpayer may modify such plan to take into account the guidance herein not later than July 11, 2005, even if the dividend to which the domestic reinvestment plan relates has already been paid. Any plan that is so modified must be subsequently approved by the taxpayer's president, chief executive officer, or comparable official, and by the taxpayer's board of directors, management committee, executive committee, or similar body.

### *.02 Tax Returns filed Prior to May 10, 2005*

If, prior to May 10, 2005, a taxpayer has filed its tax return for the taxable year for which it acquires an interest in a business entity that qualifies, in whole or in part, as a permitted investment pursuant to section 5.06 of Notice 2005–10, such taxpayer may make the election to use the fair market value methodology pursuant to section 9.05 of this notice with respect to such acquisition on an amended tax return that is filed on or before December 31, 2005.

## SECTION 12. EFFECT OF THIS NOTICE ON OTHER DOCUMENTS

Sections 9.05 and 9.06 of this notice modify section 5.06 and clarify section 3.02 of Notice 2005–10, respectively. See also section 11 of this notice, pursuant to which domestic reinvestment plans approved prior to May 10, 2005 (including domestic reinvestment plans adopted or modified pursuant to the guidance included in Notice 2005–10), may be modified to take into account the guidance in this notice.

## SECTION 13. EFFECTIVE DATE

This notice is effective for the taxable year for which taxpayers have elected section 965 to apply, and other taxable years as relevant.

<sup>7</sup> See section 3.02 of Notice 2005–10 (providing that a loan of cash from the disregarded entity to the U.S. shareholder is not considered a distribution of cash for this purpose because there is a legal obligation for the U.S. shareholder to repay the cash to the disregarded entity).

## SECTION 14. PAPERWORK REDUCTION ACT

The collections of information contained in this notice have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number [1545-1943].

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collections of information are in sections 5, 8, 9, 10, and 11 of this notice. This information is required to provide the IRS sufficient information to determine whether a taxpayer has properly elected to apply section 965 to a taxable year and whether the taxpayer has properly determined the maximum amount of cash dividends eligible for the DRD under section 965(a), taking into account the limitations on the DRD that are imposed by section 965(b)(1), (b)(2), and (b)(3). The collections of information are required to obtain the benefit of section 965 for a taxable year. The likely respondents are business corporations.

Estimated total annual reporting and/or recordkeeping burden: 1,250,000 hours.

Estimated average annual burden hours per respondent: 50 hours.

Estimated number of respondents: 25,000.

Estimated annual frequency of responses: on occasion and annually.

The collections of information contained in this notice have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be received by June 9, 2005. Comments are specifically requested concerning:

Whether the proposed collections of information are necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collections of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collections of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

Comments concerning the accuracy of the burden estimate and suggestions for reducing the burden of the final or temporary regulations should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:T:T:SP, Washington, DC 20224.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

## SECTION 15. DRAFTING INFORMATION

The principal authors of this notice are Jeffrey L. Vinnik of the Office of Associate Chief Counsel (International) and Krishna P. Vallabhaneni, formerly of the Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and the Treasury Department participated in its development. For further information regarding this notice, contact Mr. Vinnik at (202) 622-3840 (not a toll-free call).

**NOTE: This revenue procedure will be reproduced as the next revision of IRS Publication 1516, *Specifications for Filing Form 8596, Electronically or Magnetically.***

Use this revenue procedure to prepare Tax Year 2005 and prior year information returns for submission to Internal Revenue Service (IRS) using any of the following:

- Electronic Filing
- Tape Cartridge

### NOTE:

Following is a list of related forms for filing Information Returns Electronically/Magnetically:

Form 4419 — Application for Filing Information Returns Electronically/Magnetically

Form 4804 — Transmittal of Information Returns Reported Magnetically

Notice 210 — Preparation Instructions for Media Label

These forms can be obtained by calling 1-800-TAX-FORM (1-800-829-3676). You can also download forms and publications from the IRS Web Site at [www.irs.gov](http://www.irs.gov).