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A One-Time Tax Break For U.S. Multinationals

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By some estimates, U.S. multinationals have accumulated in foreign subsidiaries as much as $500 billion of income untaxed by the United States. This income, which was earned from overseas business operations, would not ordinarily be subject to U.S. tax until the foreign subsidiaries distribute it as a dividend or reinvest it in the United States. At such time, the income would normally be subject to U.S. taxation at ordinary rates of up to 35%, with a credit allowed for foreign income taxes paid by the subsidiaries.

Tax On Foreign Dividends Cut From 35% To 5 1/4%

The conventional wisdom was that the bulk of these earnings, currently parked in foreign subsidiaries would be kept outside of the United States forever, to avoid subjecting them to U.S. tax. In order to encourage the repatriation of these foreign earnings and to provide a stimulus to the domestic U.S. economy, the American Jobs Creation Act of 2004 ("Act") provides a very significant one-time inducement to bring these earnings back to the United States. The Act temporarily reduces the maximum federal income tax rate on such repatriated dividends from 35% to 5.25%. Technically, this reduction is accomplished by allowing the U.S. parent corporation to claim a dividends received deduction ("DRD") equal to 85% of the amount of the cash dividends it receives under this provision from its controlled foreign corporations ("CFCs").

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Investment In The U.S. Is Required

The DRD is only available if the dividends received by the U.S. shareholder are invested in the United States pursuant to a formal "domestic reinvestment plan" (or "DRIP"). The DRIP must be created before the dividends are paid, and must specify how they will be reinvested. The Act provides several examples of uses to which the dividends might be put, but the Conference Committee Report accompanying the Act makes it clear that the list in the statute is not intended to be exclusive. The permitted uses listed in the statute are: (1) funding of worker hiring and training; (2) infrastructure; (3) research and development; (4) capital investments; and (5) the financial stabilization of the corporation for purposes of job retention or creation. Financial stabilization is a very broad term and some commentators have suggested that even using the proceeds to fund stock buybacks may be permissible in some circumstances. Paying down debt of the U.S. parent should satisfy the financial stabilization requirement in most cases. One use explicitly prohibited is the payment of executive compensation. The DRIP must be approved by the U.S. parent's president, CEO, or comparable officer, and by the board of directors or management committee. The statute does not include any maximum time limit for the completion of the U.S. investments contemplated by the DRIP.

It should be noted that the adoption of a plan to repatriate earnings that were previously classified in the U.S. parent's consolidated financial statements as "permanently reinvested outside the United States" will require an adjustment to the parent's deferred tax liability and a corresponding charge to earnings.

Limitations On Funding The Dividend

The DRD may not be claimed to the extent that there is any increase in the indebtedness of the CFC to the U.S. parent or to any U.S. related party during the taxable year in which the dividend is paid. This is measured by comparing the amount of such indebtedness at the end of the year in which the DRD is claimed to the amount of indebtedness on October 22, 2004. This rule is intended to prevent the U.S. shareholder from financing, directly or indirectly, the payment of a dividend by the CFC, with the possible effect of there being no net repatriation of funds. A technical corrections bill pending in Congress would clarify that the Treasury Department is authorized to issue regulations providing for a similar limitation where the dividend paid by the CFC is funded by a direct or indirect capital contribution from the U.S. parent. In general, however, the Act appears to contemplate that the U.S. reinvestment requirement will be satisfied as long as the CFC dividend can be traced to a permissible U.S. investment. There does not appear to be any requirement that the total amount of the recipient's U.S. investments be increased by the amount of the dividend. Thus, nothing would seem to prevent the U.S. parent from diverting other funds that would otherwise have been invested in the United States, to foreign investments.

There is no prohibition on funding such dividends by obtaining a loan from a third party. It should also be permissible for such a third party loan to be guaranteed by the U.S. shareholder, as long as the loan is not recharacterized under common law principles as being in substance a loan to the U.S. shareholder. In addition, the limitation does not apply if the distribution is funded by a loan from another CFC.

Limitation On Amount Of DRD

The total amount of dividends for which a taxpayer may claim the DRD is subject to a cap. The cap is equal to the greater of: (1) $500 million or (2) the amount shown on the corporation's most recently audited financial statement (or a note or accompanying document) certified, or filed, on or before June 30, 2003, as earnings permanently reinvested outside the United States. Such an amount would normally appear in a note to the balance sheet explaining the amount of permanently invested earnings for which no deferred tax liability has been taken into account, as allowed by APB 23. If, instead of describing the amount of the permanently reinvested earnings, the financial statements describe the amount of tax excluded from the deferred tax liability under APB 23, then the DRD ceiling is equal to the amount of such tax divided by .35. Where a corporation is subject to the $500 million cap (because its financial statements do not show any APB 23 amount, or show such an amount that is less than $500 million) and the corporation is a member of a controlled group, the limitation amount must be shared among all the members of the controlled group.

What Is A Qualifying Dividend?

The DRD is only available for *cash* dividends or actual *cash* distributions treated as dividends (*e.g.*, in the case of certain redemptions of stock). Distributions of other property are not eligible. Deemed dividends which may result from an investment by the CFC in U.S. property are not eligible. The Conference Committee report makes it clear that a distribution made by a CFC to its U.S. parent in a complete liquidation of the CFC, which is treated as a dividend under section 367(b) of the Internal Revenue Code (Code), is eligible for the DRD.

Taxpayers might be tempted to avoid the trouble (and potential foreign tax consequences) of an actual distribution by filing a so-called "check-the-box" election to treat the CFC as if it had liquidated. However, the Conference Committee report indicates that in this case the shareholder would not be treated for purposes of the DRD as having received cash that is reinvested in the United States, as required by the Act. (It seems that Congress did not intend for the DRD to be allowed in this case even if the CFC itself invests the cash in the United States.)

Dividends From Lower-Tier CFCs

Because subpart F of the Code requires certain types of income, including dividend income earned by a CFC, to be included in the income of its U.S. shareholders in the year earned, even if not distributed, the Act includes special rules to coordinate the DRD rules with the anti-deferral provisions of subpart F. If an amount distributed to a U.S. shareholder by a CFC ("upper-tier CFC") is attributable to a dividend received from a lower-tier CFC *in the same taxable year,* the distribution received by the U.S. shareholder from the upper-tier CFC is eligible for the DRD, even though the distribution from the upper-tier CFC constitutes previously taxed subpart F income and is ordinarily not treated as a dividend (the dividend paid by the lower-tier CFC to the upper-tier CFC results in a subpart F income inclusion to the U.S. shareholder). The DRD is also available for dividends distributed indirectly through a chain of multiple CFCs.

Only Extraordinary Dividends Qualify

Since the purpose of the temporary DRD is to induce U.S. corporations to repatriate earnings that would not otherwise have been repatriated, the Act limits the DRD in circumstances where the CFC has historically made annual distributions to its U.S. shareholder. In such cases, the allowable DRD may not exceed the average of the annual distributions including distributions of previously taxed income (and reinvestments in the United States treated as distributions) during the five-year period preceding the taxable year in which the DRD is claimed (computed by ignoring the highest and lowest years in the five-year period).

Loss Of The Foreign Tax Credit

To the extent the taxpayer claims the DRD with respect to a dividend, any foreign tax paid by the shareholder with respect to such portion of the dividend (*e.g.*, a withholding tax) and any foreign income taxes paid by the CFC that would ordinarily flow through to the shareholder under section 902 of the Code may not be claimed as foreign tax credits.

Importantly, the Act allows taxpayers to designate those dividends that the taxpayer wants to treat as having been offset by the DRD. This provides the flexibility to have the foreign tax credit disallowance apply to dividends paid out of earnings and profits that were subject to a lower rate of foreign tax, while preserving the ability to claim foreign tax credits with respect to the dividends paid out of high-taxed earnings and profits.

Timing Issues

The DRD on foreign dividends is temporary and is only available for dividends received during a single taxable year of the taxpayer. The taxpayer can choose to claim it for dividends paid either during its last taxable year which begins before October 22, 2004 (for a calendar year taxpayer this would be 2004) or its first taxable year which begins after October 22, 2004 and before October 22, 2005 (for a calendar year taxpayer this would be 2005). Given the short time frame, the IRS has indicated that issuing guidance on this provision is a high priority. The IRS is likely to bypass the relatively lengthy and cumbersome process of the Treasury Department's issuing interpretive regulations, by issuing guidance in a more informal notice.

Conclusion

This new legislation represents a unique opportunity for U.S. multinationals to repatriate foreign earnings to the United States at a very low effective tax rate. However, as this article suggests, the rules are quite complex and careful attention to the statutory requirements is necessary to ensure that the benefits will be secured. Taxpayers would be well advised to wait until further guidance is issued on these provisions before relying on them to repatriate dividends from CFCs.