

Part III - Administrative, Procedural, and Miscellaneous

Foreign tax credit and other guidance under section 965

Notice 2005-64

SECTION 1. OVERVIEW

This notice is the third in a series of items of published guidance regarding new section 965 of the Internal Revenue Code (Code). This notice supplements the guidance set forth in Notice 2005-10, 2005-6 I.R.B. 474, which primarily addressed the requirements for a domestic reinvestment plan described in section 965(b)(4), and Notice 2005-38, 2005-22 I.R.B. 1100, which primarily addressed the limitations described in section 965(b)(1), (2), and (3) on the amount of dividends eligible for the dividends received deduction under section 965(a), including the effects of certain acquisitions, dispositions, and similar transactions on those limitations. This notice sets forth guidance on various issues arising under section 965, including issues relating to the foreign tax credit and minimum tax credit, expense allocation and apportionment, and currency translation. The Treasury Department and the Internal Revenue Service (IRS) expect to issue regulations that incorporate the guidance provided in Notice 2005-10, Notice 2005-38, this notice, and any subsequent guidance that may be issued addressing section 965.

The remainder of this notice is divided into 14 sections. Section 2 provides

background with respect to the issues discussed in this notice. Section 3 provides guidance on the identification of cash dividends and qualifying dividends and foreign currency translation rules for certain cash dividends. Section 4 provides guidance on the disallowance of a credit or deduction under section 965(d)(1) for foreign taxes paid or accrued with respect to the deductible portion of section 965 dividends and related issues arising under section 78. Section 5 provides guidance on the disallowance of deductions for certain expenses under section 965(d)(2). Section 6 provides rules for the treatment of deductions related to section 904(d) separate categories containing qualifying dividends. Section 7 then provides guidance on the limitation under section 965(e)(2) that prevents the reduction of taxable income below the amount of nondeductible CFC dividends. Section 8 addresses the application of the overall foreign loss and separate limitation loss allocation and recapture rules of section 904(f) to taxpayers with nondeductible CFC dividends. Section 9 provides rules for implementing the restrictions under section 965(e)(1) on the use of credits to offset U.S. tax on nondeductible CFC dividends, in part through the application of an additional foreign tax credit limitation that is applied after expenses and losses are allocated and the regular section 904(d) limitation is calculated, and provides rules relating to the computation of alternative minimum tax and the credit for prior year minimum tax in the election year. Section 10 then addresses other issues arising under section 965, including the treatment of dividends paid to certain intermediary pass-through entities for purposes of determining base period inclusions under section 965(b)(2)(B)(i). Section 11 sets forth transition rules that apply to certain taxpayers that approved a domestic reinvestment

plan or filed a tax return for a taxable year to which section 965 applies prior to the issuance of this notice. 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. 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. shareholder¹ of a controlled foreign corporation (CFC) may elect, for one taxable year, an 85 percent dividends received deduction (DRD) with respect to certain cash dividends it receives from its CFCs.² For this purpose, 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. Section 965(c)(5)(A).

For purposes of section 965, the term “cash dividends” includes cash
amounts included
in gross income as dividends under sections 302, 304, and 356(a)(2), but does not

¹ The term U.S. shareholder means, with respect to any foreign corporation, a U.S. person who owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership 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 951(b).

² Section 965(c)(4) provides that no deduction is allowed under section 243 or 245 for any dividend for which a deduction is allowed under section 965.

include subpart F inclusions or amounts treated as dividends under section 78 or 1248 or, except in certain cases, section 367. H.R. Conf. Rep. No. 108-755, at 314-15; see Notice 2005-10, sections 2 and 3. For this purpose, a cash dividend also includes a cash distribution from a CFC to a U.S. shareholder that is excluded from gross income under section 959(a) to the extent of amounts included in income by such U.S. shareholder 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(a)(2).

The amount of cash dividends eligible for the section 965(a) DRD (qualifying dividends) is determined after applying certain limitations. Notice 2005-38 addressed the rules limiting qualifying dividends to certain dollar threshold amounts determined with reference to the greater of \$500 million or the amount of earnings permanently reinvested outside the United States, the amount of dividends received in excess of certain base period average amounts, and certain increases in related-party indebtedness. See sections 965(b)(1) through (3) and 965(c). Notice 2005-10 addressed the requirement in section 965(b)(4) that the amount of the dividends be invested in the United States pursuant to a domestic reinvestment plan that meets specified criteria. Notice 2005-10 also provided rules for electing the application of section 965 for a taxable year by filing Form 8895 with a timely-filed tax return. See

section 965(b)(4) and (f). The taxable year for which a taxpayer elects section 965 to apply is referred to in this notice as the “election year.”

.02 Disallowance of Credit or Deduction for Certain Expenses Related to Deductible Portion of Qualifying Dividends and Related Matters

Section 965(d)(1) provides that no credit or deduction is allowed for certain foreign taxes paid or accrued (or treated as paid or accrued) with respect to the deductible portion of any qualifying dividend. Section 965(d)(2) further provides that no deduction shall be allowed for certain other expenses. Section 9.01 of Notice 2005-38 confirmed that section 78 does not apply to any tax which is not allowable as a credit under section 901 by reason of section 965(d) and that the disallowance of deductions in section 965(d)(2) applies only to deductions for expenses that are directly allocable to the deductible portion described in section 965(d)(1).

Section 965(d)(3) provides that, unless the taxpayer otherwise specifies, the deductible portion of any qualifying dividend is the amount which bears the same ratio to the amount of such dividend as the amount allowed as a deduction under section 965(a) for the election year bears to the total amount of dividends the taxpayer received from its CFCs during the election year, as described in section 965(b)(2)(A). For purposes of determining which dividends are subject to the foreign tax credit and expense disallowance, the taxpayer may specifically identify which cash dividends are treated as carrying the DRD (and thus entail proportionate disallowance of any associated deductions and foreign tax credits) and which are not. H.R. Conf. Rep. No. 108-755, at 316. In the absence of such a specification, a pro rata amount of foreign

tax credits and deductions will be disallowed with respect to every cash dividend repatriated during the election year. See H.R. Conf. Rep. No. 108-755, at 316 n. 112.

.03 Limitation on Use of Credits and Deductions Related to Nondeductible Portion of Qualifying Dividends

For purposes of this notice, the term “nondeductible CFC dividends” refers to the excess of the amount of qualifying dividends over the 85 percent deduction allowed for such dividends under section 965(a). See section 965(e)(3). Section 965(e) provides limitations on the extent to which credits may offset the U.S. tax on nondeductible CFC dividends, and also provides that allowable deductions may not reduce taxable income below the amount of nondeductible CFC dividends. Specifically, section 965(e)(1) provides that the U.S. tax on nondeductible CFC dividends may not be offset by tax credits, other than a foreign tax credit under section 27 for taxes attributable to such dividends and the credit for prior year minimum tax under section 53.

Section 965(e)(1) further provides that the U.S. tax on nondeductible CFC dividends is not treated as tax imposed by chapter 1 for purposes of computing the alternative minimum tax imposed by section 55 (AMT). Accordingly, the tax on nondeductible CFC dividends cannot reduce the AMT that otherwise would be owed by the taxpayer. H.R. Conf. Rep. No. 108-755, at 316.³ Section 9.01 of Notice 2005-38 provided that for purposes of calculating AMT for the election year in accordance with section 965(e)(1)(B), the taxpayer’s regular tax described in section 55(c) and tentative

³ However, the DRD is not treated as a preference item for purposes of computing the AMT. Section 56(g)(4)(C)(vi). Thus, the deduction is allowed in computing alternative minimum taxable income notwithstanding the fact that it may not be deductible in computing earnings and profits. H.R. Conf. Rep. No. 108-755, at 316-317.

minimum tax determined under section 55(b)(1)(B) do not include tax attributable to nondeductible CFC dividends.

Section 965(e)(2)(A) provides that taxable income shall in no event be less than the amount of nondeductible CFC dividends received during the election year. While the income attributable to nondeductible CFC dividends may not be offset by expenses, losses, or deductions, such amounts may have the effect of reducing the taxpayer's other income. H.R. Conf. Rep. No. 108-755, at 316 n. 113. Section 965(e)(2)(B) provides that the nondeductible CFC dividends are not taken into account in determining the amount of any net operating loss (NOL) for the election year, or in determining taxable income for the election year for purposes of the second sentence of section 172(b)(2), which applies in determining the allowable NOL carryover or carryback to that year.

SECTION 3. IDENTIFICATION OF CASH DIVIDENDS, QUALIFYING DIVIDENDS, AND SEPARATE CATEGORIES; FOREIGN CURRENCY TRANSLATION RULES

.01 *Identification of Cash Dividends*

In order for cash dividends that are paid to a partnership or a disregarded entity that is owned by a U.S. shareholder to qualify as cash dividends described in section 965(a), cash in the amount of the dividend must be received by the U.S. shareholder in the election year from the partnership or disregarded entity. See section 3.02 of Notice 2005-10. In the case of a disregarded entity, cash may be received in a form other than a distribution. See section 9.06 of Notice 2005-38 and section 10.09 of this notice. In

addition, as described in section 2.01 of this notice, under section 965(a)(2) a cash distribution from a CFC of previously-taxed earnings and profits attributable to amounts which are or have been included in income of the U.S. shareholder and are excluded from gross income under section 959(a) (previously-taxed income or PTI) is treated as a cash dividend only to the extent of amounts included in income by the U.S. shareholder under subpart F in the election year as a result of cash dividends that are both paid and distributed through a chain of CFCs to the U.S. shareholder in the election year. Finally, a deemed liquidation effected through an election under §301.7701-3(c) results in a cash dividend only to the extent the shareholder receives cash as part of the liquidation in the election year. Section 965(c)(3); see section 2, footnote 2, of Notice 2005-10. This section 3.01 provides rules for identifying the amounts treated as cash dividends if a U.S. shareholder receives cash from a partnership or disregarded entity or cash distributions of PTI from a CFC that exceed the cash dividends paid to such partnership, disregarded entity, or CFC (or the cash deemed received in a deemed liquidation) in the election year. See section 3.02 of this notice for rules for identifying specific cash dividends (including both cash dividends described in this section 3.01 and cash dividends described in section 965(a)(1) that are paid directly by a CFC to a U.S. shareholder) as qualifying dividends eligible for the section 965(a) DRD.

For purposes of this section 3, the term “eligible cash amount” refers to (a) cash received by the U.S. shareholder on any day in the election year from a partnership or disregarded entity in a form that satisfies the requirements of section 3.02 of Notice 2005-10 and section 9.06 of Notice 2005-38, and (b) cash distributions of PTI to the

U.S. shareholder on any day in the election year from a CFC. A taxpayer that receives eligible cash amounts from a disregarded entity or partnership that in the aggregate exceed the total amount of cash dividends paid to (or the amount of cash deemed received in a deemed liquidation from) such disregarded entity or the taxpayer's distributive share of cash dividends paid to such partnership during the election year, respectively, may specifically identify which eligible cash amounts are treated as attributable to the underlying cash dividends (and therefore considered to be a cash dividend described in section 965(a)(1) or (2)). Similarly, a taxpayer that receives eligible cash amounts of PTI from a CFC in excess of the amount eligible to be treated as a cash dividend under section 965(a)(2) may specifically identify which cash PTI distributions from that CFC are treated as attributable to the underlying subpart F inclusions (and therefore considered to be a cash dividend described in section 965(a)(2)).

Taxpayers make this identification by including the cash dividends and identifying information on Part V of Form 8895.⁴ Taxpayers may identify all or a portion of any specific eligible cash amount received by the U.S. shareholder from a disregarded entity, partnership or CFC in the election year as the cash dividend. To the extent a taxpayer fails to identify specific eligible cash amounts in an amount equal to the full amount of the taxpayer's share of cash dividends received by the disregarded entity, partnership or CFC, a pro rata portion of each eligible cash amount received but not

⁴ Any taxpayer that had filed its return for the election year before Form 8895 was made available to the public in final form need not file Form 8895 to identify the cash dividends, but should retain the information requested on the Form to be made available to the IRS on request.

otherwise identified by the taxpayer as a cash dividend will be treated as a cash dividend. The pro rata portion is the amount which bears the same ratio to the eligible cash amount as the unidentified portion of the taxpayer's share of the cash dividends paid to the disregarded entity, partnership or CFC bears to the total amount of eligible cash amounts received during the election year but not otherwise identified as cash dividends.

If a U.S. shareholder receives eligible cash amounts from a disregarded entity owned by the U.S. shareholder in an amount less than or equal to the total amount of cash dividends paid to the disregarded entity during the election year, then 100 percent of each eligible cash amount received from such disregarded entity is a cash dividend described in section 965(a). Similarly, if a U.S. shareholder receives eligible cash amounts from a partnership in an amount less than or equal to the total amount of the U.S. shareholder's distributive share of cash dividends paid to the partnership during the election year, then 100 percent of each eligible cash amount received from such partnership is a cash dividend described in section 965(a). Finally, if a U.S. shareholder (or a disregarded entity or partnership owned by the U.S. shareholder) receives cash distributions of PTI from a CFC in an amount less than or equal to the amount of earnings and profits included in income by the U.S. shareholder under section 951(a)(1)(A) as a result of one or more cash dividends paid to the distributing CFC or another CFC in the same chain of ownership described in section 958(a), then 100 percent of each cash distribution of PTI from that CFC is a cash dividend described in section 965(a)(2).

The taxpayer may choose to associate each cash dividend received from a disregarded entity or partnership with one or more of the cash dividends paid to that disregarded entity or partnership during the election year. Similarly, the taxpayer may choose to associate each cash dividend described in section 965(a)(2) that is received from a CFC with the earnings and profits attributable to the taxpayer's subpart F inclusion from one or more of the CFCs in the ownership chain. Taxpayers make this identification by including the identifying information required by Part V of Form 8895 and consistently calculating the tax consequences under section 965 and this notice for those cash dividends that are qualifying dividends, determined as provided in section 3.02 of this notice.⁵

.02 Identification of Qualifying Dividends and Separate Categories

In addition to other limitations, the amount of cash dividends eligible for the DRD is limited to the excess of the cash dividends received by the taxpayer from its CFCs during the election year over the taxpayer's base period amount. See section 965(b)(2) and sections 2 and 3 of Notice 2005-38. A taxpayer may specifically identify which cash dividends are treated as qualifying dividends carrying the DRD and which cash dividends are treated as meeting the base-period repatriation level or are otherwise ineligible for the DRD. H.R. Conf. Rep. No. 108-755, at 316. Taxpayers identify the qualifying dividends by completing Form 8895, Part V, column (e).⁶

⁵ See footnote 4.

⁶ Section 7.06 of Notice 2005-38 provides that an increase in a CFC's related party indebtedness is allocated among U.S. shareholders that are related persons with respect to the CFC in the order that cash dividends are received. The provision of Notice 2005-38 allocates among the U.S. shareholders the reduction in the amount of cash dividends eligible for the section 965(a) DRD, but does not preclude a U.S. shareholder from identifying any specific cash dividend as a qualifying dividend.

A taxpayer generally must identify each cash dividend received during the election year as either a qualifying dividend or a non-qualifying dividend in its entirety, but may identify a portion of one dividend as a qualifying dividend to the extent necessary to prevent the total amount identified in Part V, column (e) of Form 8895 from exceeding the total amount of qualifying dividends. To the extent a taxpayer fails to identify specific cash dividends equal to the full amount of qualifying dividends, a pro rata portion of each cash dividend received by the taxpayer during the election year that is not otherwise identified by the taxpayer as a qualifying dividend will be treated as a qualifying dividend. The pro rata portion is the amount which bears the same ratio to the amount of the dividend as the total amount of qualifying dividends not otherwise identified bears to the total amount of cash dividends received during the election year described in section 965(b)(2)(A) that are not otherwise identified as qualifying dividends. See Example 3 of section 3.05 of this notice.

Qualifying dividends described in section 965(a)(1) will be considered paid pro rata out of the non-previously-taxed earnings and profits in the CFC's separate categories from which the dividend was paid, in accordance with the look-through rules of section 904(d)(3)(D). Subpart F inclusions attributable to dividends paid to a CFC from another CFC in the same chain of ownership (including CFCs engaged in section 304 transactions described in section 9.04 of Notice 2005-38) are treated as income in the same separate categories to which the dividend is assigned, under the look-through rules of section 904(d)(3)(B) and (D). See Treas. Reg. §1.904-5. Cash dividends described in section 965(a)(2), whether or not identified by the U.S. shareholder as

qualifying dividends, will be considered paid first out of the previously-taxed earnings and profits described in section 959(c)(2) that are attributable to the amount included in the United States shareholder's income under section 951(a)(1)(A) in the election year as a result of the CFC-to-CFC cash dividend described in section 965(a)(2), to the extent thereof.

.03 Allocation of Dividends Received Deduction

The DRD allowed under section 965(a) is definitely related to and allocated to reduce gross income in the U.S. shareholder's separate categories to which the qualifying dividends described in section 965(a)(1) and the subpart F inclusions underlying qualifying dividends described in section 965(a)(2) are assigned. See Treas. Reg. §1.861-8(a)(2) and (b)(2).

.04 Foreign Currency Exchange Rate Conventions

(a) Cash dividends described in section 965(a)(1). Cash dividends described in section 965(a)(1) that are paid directly to the U.S. shareholder are translated into U.S. dollars at the spot rate on the date of distribution as provided in section 989(b)(1).⁷ 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 for purposes of section 965(a) only if and to the extent that such shareholder receives cash in the amount of the CFC dividend during the election year. See Notice 2005-10, section 3.02, Notice 2005-38, section 9.06, and section 10.09 of this notice. Such cash dividends are translated

⁷ In the case of cash received as part of a deemed liquidation resulting from an election under Treas. Reg. §301.7701-3(c), the date of distribution is the date the cash is received, not the date of the deemed liquidation.

from the functional currency of the payor CFC into U.S. dollars at the spot rate on the date the amount of the cash dividend is received by the U.S. shareholder, rather than at the spot rate on the date the dividend is received by the partnership or disregarded entity. Accordingly, the receipt of cash itself will not result in currency gain or loss to the U.S. shareholder.

(b) Cash dividends described in section 965(a)(2). Cash dividends described in section 965(a)(2) are distributions of PTI to the U.S. shareholder in an amount that does not exceed the subpart F inclusions in the election year that result from cash dividends that are paid by lower-tier CFCs and that are distributed as PTI through a chain of CFCs and received by the U.S. shareholder during the election year. The subpart F inclusions that result in cash dividends will be translated from the functional currency of the CFC receiving the dividend into U.S. dollars at the spot rate on the date the PTI is distributed to the U.S. shareholder, rather than at the average rate generally used to translate subpart F inclusions under section 989(b)(3), and the PTI distribution will not result in currency gain or loss under section 986(c).

.05 Examples

The following examples illustrate the application of section 965(d)(3) and this section 3. Unless otherwise indicated, the following facts are assumed for purposes of these examples. All corporations use calendar taxable years for U.S. tax purposes. USP is a domestic corporation that elects to apply section 965 to its 2005 taxable year and meets all applicable requirements to claim the section 965(a) DRD with respect to

the qualifying dividends described in the examples.

Example 1. Identification of cash dividends where PTI distributions exceed subpart F inclusions attributable to cash dividends. (i) Facts. USP owns all the stock of CFC1, which owns all the stock of CFC2. CFC1 and CFC2 are organized under the laws of different foreign countries and each uses the “u” as its functional currency. On September 1, 2005, CFC2 pays a cash dividend of 200u to CFC1 that is subpart F income of CFC1 under sections 952(a) and 954(c)(1)(A), resulting in a 200u income inclusion to USP under section 951(a)(1)(A). On each of March 1, 2005, when the spot exchange rate is 1u = \$1, and November 1, 2005, when the spot exchange rate is 1u = \$1.25, CFC1 distributes 200u to USP. Each of the 200u distributions is a distribution of previously-taxed earnings and profits of CFC1 that is excluded from USP’s gross income under section 959(a).

(ii) Result. USP received cash distributions of PTI from CFC1 in the election year in an amount (400u) that exceeds the amount included in income by USP under section 951(a)(1)(A) as a result of cash dividends during the election year to CFC1 from CFC2, another CFC in a chain of ownership described in section 958(a) (200u). Pursuant to section 3.01 of this notice, USP may identify either the March 1, 2005 PTI distribution of 200u = \$200 or the November 1, 2005 PTI distribution of 200u = \$250 as the cash dividend described in section 965(a)(2) of previously-taxed earnings attributable to the subpart F inclusion resulting from the cash dividend paid by CFC2 to CFC1. Pursuant to section 3.04 of this notice, USP’s subpart F inclusion of 200u is translated into U.S. dollars at the spot exchange rate on the date of the associated PTI distribution, and that PTI distribution does not result in currency gain or loss under section 986(c). The other PTI distribution may result in currency gain or loss under section 986(c).

Example 2. Identification of amounts underlying cash dividends where multiple subpart F inclusions exceed PTI distributions. (i) Facts. USP owns all the stock of CFC1, which owns all the stock of CFC2 and CFC3. CFC2 owns all the stock of CFC4. The four CFCs are each organized under the laws of a different foreign country and each uses the U.S. dollar as its functional currency. In 2005, CFC3 pays a \$100 cash dividend to CFC1 that, after taking into account \$10 of allocable foreign taxes and \$5 of other expenses, is subpart F income of CFC1 under sections 952(a) and 954(c)(1)(A) that results in an \$85 income inclusion to USP with respect to CFC1 under section 951(a)(1)(A). Also in 2005, CFC4 pays a \$100 cash dividend to CFC2 that, after taking into account \$30 of allocable taxes and \$10 of other expenses, is subpart F income of CFC2 under sections 952(a) and 954(c)(1)(A) that results in a \$60 income inclusion to USP under section 951(a)(1)(A). CFC2 distributes \$60 of cash to CFC1 and CFC1 distributes \$60 of cash to USP in 2005.

(ii) Result. USP received cash distributions of PTI from CFC1 in the election year in an amount (\$60) that is less than \$145, the total of amounts included in income

by USP under section 951(a)(1)(A) as a result of cash dividends during the election year from CFC3 to CFC1 (\$85), and cash dividends during the election year from CFC4 to CFC2 that were distributed in cash to CFC1 (\$60). Accordingly, pursuant to section 3.01 of this notice, the entire \$60 cash PTI distribution is a cash dividend described in section 965(a)(2). Furthermore, also pursuant to section 3.01 of this notice, USP may associate the \$60 cash dividend with either the \$60 cash PTI distribution to CFC1 that is attributable to the subpart F inclusion from CFC2 or a ratable portion of the \$85 subpart F inclusion from CFC1.

Example 3. Identification of qualifying dividends. (i) Facts. USP owns all the stock of CFC1 and CFC2, and CFC1 owns all the stock of CFC3. CFC1, CFC2, and CFC3 are organized under the laws of different foreign countries, and each uses the “u” as its functional currency. In 2005, CFC3 pays an 80u cash dividend to CFC1. The dividend is subpart F income of CFC1 under sections 952(a) and 954(c)(1)(A), resulting in an income inclusion to USP under section 951(a)(1)(A). Also in 2005, CFC1 distributes to USP 160u with a value of \$200 at the $0.8u = \$1$ spot exchange rate on the date of distribution, all of which constitutes previously-taxed earnings of CFC1 described in section 959(c)(2). In addition, USP receives a 100u cash dividend, equal to \$100 at the spot rate on the date of distribution, from each of CFC1 and CFC2 in 2005. USP’s base period amount described in section 965(b)(2)(B) is \$100, and, taking into account the other limitations under section 965(b), USP’s total amount of qualifying dividends is \$150.

(ii) Result. Under section 3.04 of this notice, USP’s subpart F inclusion attributable to the 80u cash dividend paid by CFC3 to CFC1 is translated into dollars at the spot rate on the date an equivalent amount of cash is distributed to USP, rather than at the average exchange rate for the year. Accordingly, USP includes \$100 in income under section 951(a)(1)(A), and 80u of the PTI distribution, which has a value of \$100 on the date of distribution, is excluded from USP’s gross income under section 959(a) and results in no currency gain or loss under section 986(c). The remaining 80u of the 160u PTI distribution, which also has a value of \$100 on the date of distribution, is excluded from USP’s gross income under section 959(a) and may result in currency gain or loss under section 986(c).

USP received three \$100 cash dividends described in section 965(b)(2)(A) during 2005, of which \$150 are eligible to be taken into account under section 965(a): the \$100 dividend from CFC2, the \$100 dividend from CFC1, and \$100 of the \$200 PTI distribution received from CFC1. The remaining \$100 of the PTI distribution received from CFC1 is not a cash dividend described in section 965(a)(2) because it exceeds the amount included in income by USP under section 951(a)(1)(A) as a result of the cash dividend paid by CFC3 to CFC1. Pursuant to section 3.02 of this notice, USP may identify any one of the three distributions in its entirety, and one-half of either of the remaining two distributions, as qualifying dividends on Form 8895. If USP does not identify specific distributions as the qualifying dividends, \$50 (\$150 total qualifying

dividends not otherwise identified divided by \$300 total cash dividends received during the election year, multiplied by \$100 cash dividend) of each of the three \$100 cash dividends will be treated as a qualifying dividend.

Example 4. Cash dividend equivalent to cash received in actual inbound liquidation. (i) Facts. USP owns all the stock of CFC1, which owns all the stock of CFC2. CFC1 and CFC2 are organized in Country X and each uses the "u" as its functional currency. On June 30, 2005, in an inbound liquidation of CFC1 described in sections 332 and 367(b), CFC1 legally dissolves and, in connection with such dissolution, USP acquires all the assets of CFC1, consisting of 100u of cash in a Country X bank account and certain other noncash assets (including all of the stock of CFC2). In connection with the liquidation USP includes in income as a dividend an all earnings and profits amount of 300u equal to \$600 on June 30, 2005, when the spot exchange rate is 1u = \$2. After the liquidation USP continues to operate the business of CFC1 in Country X with the Country X bank account.

(ii) Result. Pursuant to section 3.02 of this notice, USP may identify as a qualifying dividend described in section 965(a)(1) the 100u of cash received by USP in the liquidation of CFC1 that is taxed as a dividend under section 367(b). Pursuant to section 3.04 of this notice, the amount of the cash dividend from CFC1 is \$200 (100u of cash received by USP in the liquidation of CFC1, translated at the spot rate of 1u = \$2 on the date of the liquidating dividend).

Example 5. Cash dividends less than cash received in check-the-box liquidation plus cash dividend received by disregarded entity. (i) Facts. The facts are the same as in Example 4, except that, instead of actually liquidating CFC1, USP elects to treat CFC1 as a disregarded entity by filing an entity classification election under Treas. Reg. §301.7701-3, effective July 1, 2005, CFC2 pays a dividend of 100u to the disregarded entity CFC1 on September 1, 2005, when the spot exchange rate is 1u = \$1.50, and the disregarded entity CFC1 distributes 100u of cash to USP on October 1, 2005, when the spot exchange rate is 1u = \$1.75.

(ii) Result. USP's check-the-box election with respect to CFC1 does not give rise to an eligible dividend under section 965(c)(3) because the resulting deemed liquidation in and of itself does not result in an actual receipt by USP of the 100u of cash owned by CFC1. In addition, the cash dividend paid from CFC2 to CFC1, at that time a disregarded entity, is treated as a cash dividend received by USP in the election year only to the extent USP receives cash from the disregarded entity during the election year. See Notice 2005-10, section 3.02. Because the disregarded entity CFC1 distributed 100u of cash to USP in the year of the liquidation, the 100u cash distribution is a cash dividend within the meaning of section 965(d)(3). Pursuant to section 3.01 of this notice, USP may identify the October 1, 2005 100u cash dividend as attributable to either the deemed dividend resulting from the check-the-box election or the cash dividend paid by CFC2. If USP treats the cash dividend as attributable to cash actually

received by USP in connection with the deemed liquidation, the deemed dividend constitutes a dividend described in section 965(c)(3) to the extent of 100u. Alternatively, USP may treat the 100u cash dividend as attributable to the cash dividend paid from CFC2 to CFC1, a disregarded entity, which is eligible to be treated as a cash dividend because USP received 100u of cash from CFC1 during the election year.

If USP chooses to treat the dividend from CFC2 as the cash dividend underlying the 100u cash dividend on October 1, 2005, then pursuant to section 3.04 of this notice the dollar amount of the 100u dividend from CFC2 is \$175, the spot value of 100u on October 1, 2005, the date CFC1 distributes an amount of cash equal to the CFC2 dividend to USP, and CFC1's distribution of 100u to USP does not give rise to currency gain or loss. As in Example 4, the entire 300u all earnings and profits amount is \$600, translated into dollars at the 1u = \$2 exchange rate, the spot rate on the date of the deemed dividend.

If, instead, USP chooses to treat the 100u cash dividend as cash received in connection with the deemed liquidation, pursuant to section 3.04 of this notice the dollar amount of 100u of the 300u deemed dividend from CFC1 is \$175, the spot value of 100u on October 1, 2005, the date USP receives that amount of cash in connection with the deemed liquidation. The dollar amount of the 200u remainder of the deemed dividend is \$400, translated into dollars at the 1u = \$2 exchange rate, the spot rate on the date of the deemed dividend. The dollar amount of the 100u dividend from CFC2 is \$150, the spot value of 100u on September 1, 2005, the date CFC2 paid the dividend to the disregarded entity CFC1.

Example 6. CFC-to-CFC dividend and equivalent PTI distribution. (i) Facts. USP owns all the stock of CFC1, which owns all the stock of CFC2. CFC1 is organized in Country X and uses the "u" as its functional currency. CFC2 is organized in Country Y and uses the euro as its functional currency. On June 30, 2005, when the spot exchange rate is 1u = €2, CFC2 pays a cash dividend of €200 to CFC1. CFC1 has no other items of income or expense in 2005. The dividend from CFC2 is subpart F income of CFC1 under sections 952(a)(2) and 954(c)(1)(A) that is included in income by USP under section 951(a)(1)(A)(i). On September 1, 2005, when the spot exchange rate is 1u = \$1, CFC1 distributes 100u in cash to USP. The 100u cash distribution is PTI of CFC1 that is excluded from USP's income under section 959(a). The average exchange rate determined under section 989(b)(3) for 2005 is 1u = \$.90.

(ii) Result. Pursuant to section 989(b)(1), the "u" amount of CFC1's subpart F income attributable to the €200 dividend from CFC2 is 100u, the spot value of €200 on the date CFC1 includes the CFC2 dividend in income. The 100u cash distribution from CFC1 to USP is a cash dividend described in section 965(a)(2) because it is PTI in an amount not in excess of the 100u subpart F income of CFC1 that results from a cash dividend paid during the election year by CFC2, another CFC in the chain of ownership described in section 958(a). Regardless of whether USP identifies the PTI distribution

from CFC1 as a qualifying dividend, pursuant to section 3.04 of this notice the dollar amount of USP's subpart F inclusion with respect to CFC1 under section 951(a)(1)(A) attributable to the CFC2 dividend is \$100, the spot rate on the date CFC1 distributes an amount of cash equal to the CFC2 dividend to USP. The PTI distribution does not result in currency gain or loss under section 986(c).

Example 7. CFC-to-CFC dividend and smaller PTI distribution. (i) Facts. The facts are the same as in Example 6, except that CFC2's dividend to CFC1 is €400 rather than €200.

(ii) Result. The €400 dividend, translated at the spot rate on the date of distribution from CFC2 to CFC1, results in 200u of subpart F income of CFC1 that is included in USP's income in the election year. The result with respect to the 100u of the subpart F inclusion and resulting PTI that CFC1 distributes to USP in the election year are the same as in Example 6. USP's subpart F inclusion with respect to the remaining 100u of CFC1's subpart F income that is not distributed is \$90 (100u translated at the average exchange rate of 1u = \$.90). CFC1's distribution of the remaining 100u of PTI to USP after the election year is not subject to the rules of this notice and may give rise to currency gain or loss under section 986(c).

SECTION 4. DISALLOWANCE OF CREDIT OR DEDUCTION FOR FOREIGN TAXES ON DEDUCTIBLE PORTION OF QUALIFYING DIVIDENDS

.01 Identification of Foreign Income Taxes Paid or Accrued with Respect to the Deductible Portion of Qualifying Dividends

Under section 965(d)(1), no credit or deduction is allowed for foreign taxes described in section 901 that are paid or accrued (or treated as paid or accrued) with respect to the deductible portion of each qualifying dividend, including distributions of PTI that are treated as cash dividends under section 965(a)(2). This disallowance applies to 85 percent of the U.S. dollar amount of (1) foreign taxes paid or accrued by the U.S. shareholder with respect to the qualifying dividend (including the U.S. shareholder's distributive share of foreign taxes that are paid or accrued by a partnership with respect to the dividend and that are properly allocated to the U.S.

shareholder-partner under the rules of sections 702 and 704 and the regulations thereunder and separately stated to the partner under Treas. Reg. §1.702-1(a)(6)); (2) foreign taxes deemed paid under section 902 with respect to a qualifying dividend described in section 965(a)(1); and (3) foreign taxes deemed paid under section 960, including taxes described in section 960(a)(3), with respect to a subpart F inclusion resulting from a CFC-to-CFC dividend and the associated PTI distribution described in section 965(a)(2).

Section 965 does not modify the computation of foreign taxes deemed paid under sections 902 and 960. As a result, for purposes of section 902 the post-1986 undistributed earnings, post-1986 foreign income taxes, pre-1987 accumulated profits, pre-1987 foreign income taxes, and previously-taxed earnings and profits and tax accounts of CFCs paying qualifying dividends are reduced by the full amount of earnings distributed and the full amount of foreign taxes attributable to the distributed earnings, without regard to the amount of the DRD or the amount of foreign tax for which section 965(d)(1) disallows a credit or deduction.

.02 Section 78 Gross-Up

Under section 78, an amount equal to the taxes deemed paid under section 902(a) or section 960(a)(1) by a domestic corporation generally is included in income as a dividend if the domestic corporation chooses the benefits of the foreign tax credit for the taxable 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). See also section 9.01 of Notice 2005-38.

.03 Examples

The following examples illustrate the application of section 965(d)(1) and this section 4. Unless otherwise indicated, the following facts are assumed for purposes of these examples. All corporations use calendar taxable years for U.S. tax purposes. USP is a domestic corporation that elects to apply section 965 to its 2005 taxable year and meets all applicable requirements to claim the section 965(a) DRD with respect to the qualifying dividends described in the examples. All the earnings and profits and creditable foreign taxes of each CFC constitute general limitation post-1986 undistributed earnings and general limitation post-1986 foreign income taxes, and no exceptions apply to prevent USP from including in income its pro rata share of any CFC's subpart F income in the election year. Except as specifically provided, a CFC has no other items of gross income or expense for the election year, has no previously-taxed earnings and profits described in section 959(c)(1) or (2), and makes no distributions in the election year.

Example 1. Qualifying dividend under section 965(a)(1) from first-tier CFC. (i) Facts. USP owns all the stock of CFC1, a foreign corporation that uses the "u" as its functional currency. On June 30, 2005, CFC1 pays a cash dividend of 80u, equal to \$100 translated at the spot rate on that date of $0.8u = \$1$, out of its post-1986 undistributed earnings to USP. The dividend is subject to a 10 percent withholding tax of $8u = \$10$, so USP receives cash of \$90. USP has a base period amount of \$0 and its total amount of qualifying dividends is \$100. As of the close of 2005, computed without regard to the June 30 distribution to USP, CFC1 has post-1986 undistributed earnings of 800u and post-1986 foreign income taxes of \$200.

(ii) Result. Under section 902(a), \$20 ($(80u/800u) \times \200) of foreign income taxes are deemed paid by USP with respect to the \$100 dividend from CFC1. Subject to other applicable limitations, USP may claim a foreign tax credit or deduction for \$1.50 (15 percent of the \$10 withholding tax), and may also claim a credit for \$3 (15 percent of the \$20 of deemed-paid taxes). Under section 965(d)(1), no credit or deduction is allowed for the remaining \$8.50 of withholding tax or \$17 of deemed-paid tax, which

represent the taxes paid or deemed paid with respect to the 85 percent deductible portion of the \$100 dividend. USP includes \$100 in gross income and claims an \$85 DRD under section 965(a) with respect to the qualifying dividend of \$100 described in section 965(a)(1). If USP elects to credit foreign taxes in 2005, USP also includes \$3 in income under section 78. No gross-up is required under section 78 for the \$17 of deemed-paid tax which is not allowed as a credit. CFC1's post-1986 undistributed earnings and post-1986 foreign income taxes are reduced by the full amount of earnings distributed and foreign taxes deemed paid in 2005, without regard to the amount of the DRD under section 965(a) or the disallowance under section 965(d)(1) of a credit for taxes deemed paid with respect to the deductible portion of the qualifying dividend. Accordingly, CFC1's post-1986 undistributed earnings and post-1986 foreign income taxes, computed as of January 1, 2006, are 720u (800u - 80u) and \$180 (\$200 - \$20), respectively.

Example 2. Qualifying dividend under section 965(a)(1) from first-tier CFC to disregarded entity. (i) Facts. USP is the sole owner of DE, a disregarded entity organized in Country X. DE owns all the stock of CFC1, which is incorporated in Country Y. Each of DE and CFC1 uses the U.S. dollar as its functional currency. On June 30, 2005, CFC1 pays a cash dividend of \$135 to DE, with respect to which USP is deemed under section 902(a) to pay \$20 of foreign income tax paid by CFC1. DE pays Country Y withholding tax of \$20 and Country X net income tax of \$15 with respect to the dividend from CFC1. Also on June 30, 2005, DE distributes \$135 to USP. The distribution from DE is not subject to Country X withholding tax. USP has a base period amount of \$0 and qualifying dividends of \$135.

(ii) Result. USP is entitled to a DRD of \$114.75 ($.85 \times \135) under section 965(a) with respect to the \$135 dividend paid by CFC1 to DE and distributed in cash to USP in 2005. Subject to other applicable limitations, USP may claim a foreign tax credit or deduction for \$5.25 (15 percent of the \$35 of foreign tax paid by DE), and may also claim a credit for \$3 (15 percent of the \$20 of foreign taxes paid by CFC1 that are deemed paid by USP with respect to the dividend paid by CFC1). If USP elects to credit foreign taxes in 2005, USP includes \$3 in income under section 78. No gross-up is required under section 78 for the \$17 of deemed-paid tax which is not allowed as a credit. Under section 965(d)(1), no credit or deduction is allowed for the remaining \$29.75 of tax paid under section 901 or \$17 of tax deemed paid under section 902, which represent the taxes paid or deemed paid with respect to the 85 percent deductible portion of the \$135 qualifying dividend. CFC1's post-1986 undistributed earnings and post-1986 foreign income taxes, computed as of January 1, 2006, are reduced by \$135 and \$20, respectively.

Example 3. Qualifying dividend under section 965(a)(2) attributable to dividend from second-tier CFC, subpart F inclusion, and PTI distribution from first-tier CFC to USP. (i) Facts. USP owns all the stock of CFC1, which owns all the stock of CFC2. CFC1 is incorporated in Country X, and CFC2 is incorporated in Country Y. Each of

CFC1 and CFC2 uses the U.S. dollar as its functional currency. On June 30, 2005, CFC2 pays a cash dividend of \$135 to CFC1. CFC1 pays Country Y withholding tax of \$20 and Country X net income tax of \$15 with respect to the dividend from CFC2. CFC1 has no other items of income or expense in 2005, so its subpart F income and earnings and profits for 2005 are \$100, all attributable to the dividend from CFC2, and USP includes \$100 in income under section 951(a)(1)(A) with respect to CFC1 for 2005. Also on June 30, 2005, CFC1 distributes \$100 of cash to USP. The PTI distribution is subject to Country X withholding tax of \$10. As of the close of 2005, including taxes paid and deemed paid under section 902(b) by CFC1 with respect to the distribution from CFC2 but before accounting for the effect of the subpart F inclusion or distribution to USP, CFC1 has post-1986 undistributed earnings of \$1,000 and post-1986 foreign income taxes of \$200. USP has a base period amount of \$0 and qualifying dividends of \$100.

(ii) Result. Under sections 960(a)(1) and 902(a), \$20 $((\$100/\$1,000) \times \$200)$ of foreign income taxes are deemed paid by USP with respect to the \$100 subpart F inclusion attributable to CFC1. Under section 965(a)(2), the cash distribution of PTI from CFC1 is a qualifying dividend to the extent of \$100, the amount USP included in income under section 951(a)(1)(A) in 2005 as a result of the cash dividend paid from CFC2 to CFC1 in 2005. USP is entitled to a DRD of \$85 under section 965(a) with respect to the \$100 subpart F inclusion and associated PTI distribution. Subject to other applicable limitations, USP may claim a foreign tax credit or deduction for 15 percent of the \$10 withholding tax, or \$1.50, and may claim a credit for 15 percent of the \$20 of deemed-paid taxes, or \$3. If USP elects to credit foreign taxes in 2005, USP includes \$3 in income under section 78. No gross-up is required under section 78 for the \$17 of deemed-paid tax which is not allowed as a credit. Under section 965(d)(1), no credit or deduction is allowed for the remaining \$8.50 of withholding tax or \$17 of deemed-paid tax, which represent the taxes paid or deemed paid with respect to the 85 percent deductible portion of the \$100 qualifying dividend. CFC1's post-1986 undistributed earnings and post-1986 foreign income taxes, computed as of January 1, 2006, are \$900 $(\$1,000 - \$100)$ and \$180 $(\$200 - \$20)$, respectively.

Example 4. Qualifying dividend under section 965(a)(2) attributable to multiple dividends from second-tier CFCs, subpart F inclusion, and distribution from first-tier CFC to USP. (i) Facts. USP owns all the stock of CFC1, which owns all the stock of CFC2 and CFC3. CFC1, CFC2, and CFC3 are organized under the laws of different foreign countries, and each uses the "u" as its functional currency. In 2005, CFC2 and CFC3 each pays an 80u cash dividend to CFC1 that is subpart F income of CFC1 under sections 952(a) and 954(c)(1)(A) that results in an income inclusion to USP under section 951(a)(1)(A). Under section 902(b)(1), CFC1 is deemed to pay foreign taxes of \$8 with respect to the 80u dividend from CFC2, and CFC1 is deemed to pay foreign taxes of \$40 with respect to the 80u dividend from CFC3.

Also in 2005, CFC1 makes two distributions of 80u, totaling 160u, to USP, all of

which constitutes previously-taxed earnings and profits of CFC1 described in section 959(c)(2). The first 80u distribution has a value of \$100 at the $0.8u = \$1$ spot exchange rate on the date of distribution, and the second 80u distribution has a value of \$80 at the $1u = \$1$ spot exchange rate on the date of distribution. Under section 3.04 of this notice, USP's subpart F inclusion attributable to CFC1's 160u of foreign personal holding company income attributable to cash dividends paid by CFC2 and CFC3 is translated into dollars at the spot rate on the dates an equivalent amount of cash is distributed to USP, rather than at the average exchange rate for the year. Accordingly, USP includes \$180 ($\$100 + \80) in income under section 951(a)(1)(A), and neither of the 80u PTI distributions results in exchange gain or loss under section 986(c). USP's total cash dividends are \$180. USP has a base period amount of \$80 and qualifying dividends of \$100.

As of the close of 2005, taking into account the dividends received from CFC2 and CFC3 and the associated deemed-paid taxes but before giving effect to the subpart F inclusion to USP, CFC1 has post-1986 undistributed earnings of 1,600u and post-1986 foreign income taxes of \$400.

(ii) Result. Under sections 960(a)(1) and 902(a), $\$40 ((160u/1,600u) \times \$400)$ of foreign income taxes are deemed paid by USP with respect to the 160u subpart F inclusion attributable to CFC1. Of this amount, \$20 is attributable to the first cash dividend of $80u = \$100$, and \$20 is attributable to the second cash dividend of $80u = \$80$. If USP identifies the first distribution in its entirety as the qualifying dividend, USP is entitled to a DRD of \$85 under section 965(a) with respect to the \$100 subpart F inclusion and associated PTI distribution. Subject to other applicable limitations, USP may claim a foreign tax credit for \$23, equal to the sum of \$3 ($.15 \times \20) of deemed-paid taxes attributable to the qualifying dividend and \$20 of deemed-paid taxes attributable to the remaining \$80 of the subpart F inclusion. If USP elects to credit foreign taxes in 2005, USP includes \$23 in income under section 78. Under section 965(d)(1), no credit is allowed for the remaining \$17 of deemed-paid taxes, which are attributable to the 85 percent deductible portion of the \$100 qualifying dividend. No gross-up is required under section 78 for the \$17 of deemed-paid tax which is not allowed as a credit.

If, instead, USP identifies \$20 of the \$100 first cash dividend and the entire \$80 of the second cash dividend as the qualifying dividends, USP is entitled to a DRD of \$17 ($.85 \times \20) with respect to the first qualifying dividend and \$68 ($.85 \times \80) with respect to the second qualifying dividend, for a total DRD of \$85. Subject to other applicable limitations, USP may claim a foreign tax credit for \$19.60, equal to the sum of \$0.60 ($.15 \times (\$20/\$100) \times \20) of deemed-paid taxes attributable to the \$20 qualifying dividend, \$16 ($(\$80/\$100) \times \20) of deemed-paid taxes attributable to the remaining \$80 of the subpart F inclusion associated with the first cash dividend, and \$3 ($.15 \times \20) of deemed-paid taxes attributable to the \$80 qualifying dividend. If USP elects to credit foreign taxes in 2005, USP includes \$19.60 in income under section 78. Under section

965(d)(1), no credit is allowed for the remaining \$20.40 (\$3.40 + \$17) of deemed-paid taxes, which are attributable to the 85 percent deductible portion of the \$20 and \$80 qualifying dividends. No gross-up is required under section 78 for the \$20.40 of deemed-paid tax which is not allowed as a credit.

Because under sections 960(a)(1) and 902(a) USP's foreign taxes deemed paid with respect to the subpart F inclusion underlying the qualifying dividends described in section 965(a)(2) are computed on the basis of CFC1's year-end post-1986 undistributed earnings and post-1986 foreign income taxes, a ratable portion of CFC1's post-1986 foreign income taxes, and not the specific taxes associated with the underlying dividends from CFC2 and CFC3, are considered attributable to the qualifying dividends.

Example 5. Qualifying dividend under section 965(a)(2) attributable to dividend from third-tier CFC, subpart F inclusion from second-tier CFC, and distribution through first-tier CFC to USP. (i) Facts. USP owns all the stock of CFC1, which owns all the stock of CFC2, which owns all the stock of CFC3. CFC1 is incorporated in Country X, CFC2 is incorporated in Country Y, and CFC3 is incorporated in Country Z. Each of CFC1, CFC2, and CFC3 uses the U.S. dollar as its functional currency. On June 30, 2005, CFC3 pays a dividend of \$150 to CFC2. CFC2 pays Country Z withholding tax of \$20 and Country Y net income tax of \$15 with respect to the dividend from CFC3. CFC2 has no other items of income or expense in 2005, so its subpart F income and earnings and profits for 2005 are \$115, all attributable to the dividend from CFC3, and USP includes \$115 in income under section 951(a)(1)(A) with respect to CFC2 for 2005. Also on June 30, 2005, CFC2 distributes \$115 of cash to CFC1 that is PTI excluded from CFC1's gross income under section 959(b). The distribution is subject to \$10 of Country Y withholding tax and \$5 of Country X income tax in the hands of CFC1, which are taxes on PTI excluded from CFC1's post-1986 foreign income taxes and accounted for under section 960(a)(3). Later in 2005, CFC1 distributes \$100 of PTI to USP. USP pays \$10 of withholding tax to Country X with respect to the \$100 PTI distribution, receiving cash of \$90. As of the close of 2005, including taxes paid and deemed paid under section 902(b) by CFC2 with respect to the distribution from CFC3 but before accounting for the effect of the subpart F inclusion or distribution to CFC1, CFC2 has post-1986 undistributed earnings of \$1,150 and post-1986 foreign income taxes of \$200. USP has a base period amount of \$0.

(ii) Result. Under sections 960(a)(1) and 902(a), \$20 $((\$115/\$1,150) \times \$200)$ of foreign income taxes paid by CFC2 are deemed paid by USP with respect to the \$115 subpart F inclusion attributable to CFC2. Under section 960(a)(3), \$15 of foreign taxes (\$10 of withholding tax and \$5 of income tax) paid by CFC1 with respect to the \$115 distribution of PTI from CFC2 are deemed paid by USP with respect to the \$100 of remaining PTI distributed from CFC1 to USP. However, under section 965(a)(2), the \$100 PTI distribution from CFC1 is a cash dividend and, therefore, a qualifying dividend only to the extent of \$100, the lesser of the amount USP included in income under

section 951(a)(1)(A) in 2005 as a result of the cash dividend paid from CFC3 to CFC2 in 2005 (\$115) or the amount of the PTI distribution from CFC1 to USP (\$100). The amount of foreign taxes deemed paid under section 960(a)(1) with respect to the \$100 section 965(a)(2) dividend is \$17.39 ($(\$100/\$115) \times \20), and the amount of foreign taxes deemed paid under section 960(a)(3) with respect to the \$100 PTI distribution is \$15.

USP is entitled to a DRD of \$85 under section 965(a) with respect to \$100 of the \$115 subpart F inclusion and associated PTI distribution. Subject to other applicable limitations, USP may claim a foreign tax credit or deduction for \$1.50 (15 percent of the \$10 withholding tax imposed on the \$100 PTI distribution), and may claim a credit for \$2.61 (15 percent of the \$17.39 of taxes deemed paid under section 960(a)(1) with respect to the \$100 qualifying portion of the subpart F inclusion from CFC2), plus \$2.25 (15 percent of the \$15 of tax deemed paid under section 960(a)(3) with respect to the \$100 PTI distribution). USP may also claim a credit for the \$2.61 of foreign tax deemed paid under section 960(a)(1) with respect to the \$15 of USP's subpart F inclusion that does not result in a qualifying dividend. If USP elects to credit foreign taxes in 2005, USP includes \$5.22 in income under section 78 with respect to the \$2.61 of foreign tax deemed paid under section 902 with respect to the \$15 nondeductible CFC dividend and the \$2.61 of foreign tax deemed paid under section 960(a)(1) with respect to the \$15 of USP's subpart F inclusion that does not result in a qualifying dividend. No gross-up is required under section 78 with respect to the \$2.25 of taxes deemed paid under section 960(a)(3), equal to 15 percent of the \$15 of the taxes paid by CFC1 on the \$115 PTI distribution from CFC2, which was included in USP's income under section 951(a)(1)(A). Under section 965(d)(1), no credit or deduction is allowed for the remaining \$8.50 of withholding tax, \$14.78 of tax deemed paid under section 960(a)(1), or \$12.75 of tax deemed paid under section 960(a)(3), which represent the taxes paid or deemed paid with respect to the 85 percent deductible portion of the \$100 qualifying dividend. No gross-up is required under section 78 for the \$14.78 of tax deemed paid under section 960(a)(1) which is not allowed as a credit or for any portion of the taxes deemed paid under section 960(a)(3). CFC2's post-1986 undistributed earnings and post-1986 foreign income taxes, computed as of January 1, 2006, are \$1,035 (\$1,150 - \$115) and \$180 (\$200 - \$20), respectively.

Example 6. Qualifying dividend under section 965(a)(2) attributable to dividend from third-tier CFC, subpart F inclusion from second-tier CFC, distribution through first-tier CFC to USP, and additional PTI distribution. (i) Facts. The facts are the same as Example 5, except that CFC1 distributes an additional \$15 of PTI described in section 959(c)(2) to USP in the election year, subject to Country X withholding tax of \$1.50. The additional \$15 of PTI is attributable to subpart F income of CFC1 that was included in USP's income in a year prior to the election year.

(ii) Result. The additional \$15 of PTI distributed is a cash dividend that is eligible to be treated as a qualifying dividend described in section 965(a)(2) because during the

election year USP included \$115 in income under section 951(a)(1)(A) attributable to the cash dividend paid from CFC3 to CFC2, and CFC2 made cash distributions described in section 959(b) of \$115 to CFC1. USP may identify the additional \$15 PTI distribution as a qualifying dividend and claim an 85 percent DRD of \$12.75 with respect to the remaining \$15 of the subpart F inclusion resulting from the dividend paid by CFC3 to CFC2. The amount of foreign taxes deemed paid under section 960(a)(1) with respect to the \$115 of section 965(a)(2) dividends is \$20 ($\$115/\$115 \times \20), and the amount of foreign taxes deemed paid under section 960(a)(3) with respect to the \$115 of PTI distributions is \$15 (\$15 of foreign taxes paid by CFC1 with respect to the \$115 distribution of PTI from CFC2). Subject to other applicable limitations, USP may claim a foreign tax credit or deduction for \$1.73 (15 percent of the \$11.50 withholding tax imposed on the \$115 PTI distribution), and may claim a credit for \$3 (15 percent of the \$20 of taxes deemed paid under section 960(a)(1) with respect to the \$115 subpart F inclusion from CFC2), plus \$2.25 (15 percent of the \$15 of tax deemed paid under section 960(a)(3) with respect to the \$115 PTI distribution). If USP elects to credit foreign taxes in 2005, USP includes \$3 in income under section 78. Under section 965(d)(1), no credit or deduction is allowed for the remaining \$9.77 of withholding tax, \$17 of tax deemed paid under section 960(a)(1), or \$12.75 of tax deemed paid under section 960(a)(3), which represent the taxes paid or deemed paid with respect to the 85 percent deductible portion of the \$115 qualifying dividend. No gross-up is required under section 78 for the \$17 of tax deemed paid under section 960(a)(1) which is not allowed as a credit or for any portion of the taxes deemed paid under section 960(a)(3). The adjustments to CFC2's post-1986 undistributed earnings and post-1986 foreign income taxes are the same as in Example 5.

SECTION 5. DISALLOWANCE OF DEDUCTIONS FOR CERTAIN EXPENSES RELATED TO DEDUCTIBLE PORTION OF QUALIFYING DIVIDENDS

.01 *Expenses Incurred by Taxpayer*

The disallowance of deductions for expenses under section 965(d)(2) applies only to expenses that are directly allocable to the deductible portion of qualifying dividends. See section 9.01 of Notice 2005-38. Therefore, section 965(d)(2) disallows a deduction for 85 percent of directly allocable expenses, which are those expenses that relate directly to generating qualifying dividends. These expenses are:

- (a) Stewardship expenses described in Treas. Reg. §1.861-8(e)(4) that are

definitely related and allocable to qualifying dividends;

(b) Legal, tax, accounting, consulting and similar fees and expenses, including expenses for employee compensation, for the rendering of advice and the preparation of documents directly related to (i) plans to repatriate earnings in the election year, including the determination of the potentially eligible amount of qualifying dividends, the decision to repatriate earnings from particular CFCs, and the identification of particular distributions as cash dividends, qualifying dividends, or other amounts, (ii) the adoption and approval of a domestic reinvestment plan, and (iii) the declaration and payment of qualifying dividends;

(c) Fees and expenses related to tax accounting and reporting for qualifying dividends in the election year; and

(d) Wire transfer, currency exchange, and similar fees incurred in connection with the payment of qualifying dividends.

For purposes of this section 5.01, only a pro rata portion of stewardship expenses accrued in the election year with respect to each CFC in which the taxpayer is a U.S. shareholder is considered definitely related and allocable to qualifying dividends.

The pro rata portion is the amount that bears the same ratio to the stewardship expenses as the qualifying dividends paid by a CFC bear to the total amount of dividends and subpart F inclusions included in the U.S. shareholder's income with respect to that CFC and subpart F inclusions attributable to stock of any other CFCs held indirectly by the U.S. shareholder in the same chain of ownership described in section 958(a) in the election year. Deductions for other directly allocable expenses

described in the preceding paragraph are subject to disallowance in the year paid or accrued, whether that year is the election year or a different taxable year.

Deductions for the allowable 15 percent portion of expenses that are directly allocable to qualifying dividends are allocated and apportioned in accordance with the generally applicable rules of sections 861 through 865 and the regulations thereunder. See section 6 of this notice.

The disallowance of deductions under section 965(d)(2) does not extend to expenses that, while treated as definitely related to the production of income in a category that includes qualifying dividends, do not relate directly to generating qualifying dividends. Expenses described in the preceding sentence include interest expense, research and experimental expenses, general and administrative expenses, depreciation and amortization, sales and marketing expenses, state and local taxes, and any other expenses not described in the first paragraph of this section 5.01. In addition, legal, tax, accounting, consulting, and similar fees and expenses related to the implementation of investments in the United States contemplated by a domestic reinvestment plan are not considered directly allocable to qualifying dividends.

.02 Expenses Incurred by CFCs

Deductions for expenses properly incurred by CFCs that are otherwise deductible in computing subpart F income and earnings and profits are not limited by section 965(d)(2).

SECTION 6. ALLOCATION AND APPORTIONMENT OF EXPENSES TO SEPARATE

CATEGORIES WITH QUALIFYING DIVIDENDS

.01 No New Separate Category

Section 965 does not provide for qualifying dividends to be assigned to a special separate category or otherwise modify the generally applicable look-through rules of section 904(d)(3) for determining the separate category to which dividends and subpart F inclusions from CFCs are assigned. For purposes of allocating expenses on the basis of assets in the election year, stock of CFCs paying qualifying dividends is characterized under the generally applicable rules of Treas. Reg. §1.861-12T(c)(3).

.02 Treatment of CFC Stock and Qualifying Dividends under Section 864(e)

The first sentence of section 864(e)(3) (section 864(e)(3)(A) for transactions before January 1, 2005) provides that, for purposes of allocating and apportioning any deductible expense, any tax-exempt asset (and any income from such an asset) shall not be taken into account. The second sentence of section 864(e)(3) provides that a similar rule applies in the case of the portion of certain dividends equal to the deduction allowable under section 243 or 245(a) with respect to such dividend, and in the case of a like portion of any stock the dividends on which would be so deductible. A qualifying dividend is not exempt income, and the CFC stock on which qualifying dividends are paid is not an exempt asset, within the meaning of the first sentence of section 864(e)(3). In addition, the similar rule in the second sentence of section 864(e)(3) does not apply to qualifying dividends or the CFC stock on which qualifying dividends are paid, since no deduction is allowed under section 243 or 245 for any dividend for which a deduction is allowed under section 965. Section 965(c)(4). Accordingly, gross

income attributable to a qualifying dividend is not considered exempt income, and no portion of the stock of a CFC paying a qualifying dividend is considered an exempt asset, for purposes of allocating and apportioning interest and other expenses in the election year.

.03 Expenses Allocated and Apportioned to Separate Categories that Include Qualifying Dividends

Section 965 does not modify the generally applicable rules of sections 861 through 865 and the regulations thereunder for allocating and apportioning expenses and losses to separate categories described in section 904(d)(1) and Treas. Reg. §1.904-5(m) (separate categories) that include nondeductible CFC dividends. However, the amount of nondeductible CFC dividends in a separate category must be determined for purposes of applying the limitations on the allowable foreign tax credit for the election year under section 904 and section 965(e)(1) and related computations under sections 53 and 55. See sections 7, 8, and 9 of this notice. For this purpose, expenses that are allocated and apportioned to a separate category that includes qualifying dividends will be considered to reduce other foreign source gross income in the separate category before reducing foreign source income attributable to nondeductible CFC dividends. Except as provided in section 7.01 of this notice (relating to the taxable income limitation of section 965(e)(2)(A)), if expenses and other deductions properly allocated and apportioned to foreign source gross income in a separate category exceed the amount of foreign source gross income exclusive of nondeductible CFC dividends in that separate category, such excess will reduce foreign source income

attributable to nondeductible CFC dividends in the separate category to the extent thereof, and any excess deductions will constitute a separate limitation loss described in section 904(f)(5). See section 8 of this notice for rules relating to the allocation and recapture of separate limitation losses in the election year and subsequent years.

The amount of qualifying dividends eligible for the DRD, the amount of nondeductible CFC dividends described in section 965(e)(3), and the amount of taxable income for the election year are determined without regard to the manner in which deductible expenses are allocated and apportioned in the election year. Therefore, the amount of the section 965(a) DRD, the amount of foreign taxes and expenses for which credit or deduction is disallowed under section 965(d), the amount of taxable income determined under section 965(e)(2)(A), and the allowable NOL deduction determined under section 965(e)(2)(B) are not affected if nondeductible CFC dividends in a separate category are reduced or eliminated by reason of the allocation and apportionment of expenses pursuant to sections 861 through 865 and the regulations thereunder and this section 6.

.04 Examples

The following examples illustrate the application of this section 6. Expenses described in the examples do not include any expenses for which a deduction is disallowed under section 965(d)(2) or any other applicable Code provision.

Example 1. Separate limitation income exceeds nondeductible CFC dividends.
(i) Facts. USP has the following items of gross income and expense for the election year: \$1,200 of foreign source general limitation gross income, including \$1,000 of qualifying dividends, \$1,000 of expenses allocated and apportioned to general limitation income (including the 85 percent DRD of \$850, which pursuant to section 3.03 of this notice is allocated to reduce general limitation income), \$300 of U.S. source gross

income, and \$100 of expenses allocated and apportioned to U.S. source income. Accordingly, USP has \$400 of taxable income and \$150 of nondeductible CFC dividends in the election year, and the taxable income limitation of section 965(e)(2)(A) does not apply.

(ii) Result. Under section 6.03 of this notice, general limitation expenses are considered to reduce other general limitation income before reducing nondeductible CFC dividends. Accordingly, USP has \$200 of foreign source general limitation taxable income, of which \$150 is attributable to nondeductible CFC dividends, and \$200 of U.S. source taxable income.

Example 2. Nondeductible CFC dividends exceed separate limitation income; nondeductible CFC dividends reduced. (i) Facts. The facts are the same as in Example 1, except that USP has an additional \$100 of deductible expenses allocated and apportioned to general limitation income. Accordingly, USP has \$300 of taxable income and \$150 of nondeductible CFC dividends in the election year, and the taxable income limitation of section 965(e)(2)(A) does not apply.

(ii) Result. Under section 6.03 of this notice, general limitation expenses reduce nondeductible CFC dividends after reducing other general limitation income. Accordingly, USP has \$100 of foreign source general limitation income, all attributable to nondeductible CFC dividends, and \$200 of U.S. source taxable income.

Example 3. Nondeductible CFC dividends exceed separate limitation income; separate limitation loss with U.S. source taxable income. (i) Facts. The facts are the same as in Example 1, except that USP has an additional \$250 of deductible expenses allocated and apportioned to general limitation income. Accordingly, USP has \$150 of taxable income and \$150 of nondeductible CFC dividends in the election year, and the taxable income limitation of section 965(e)(2)(A) does not apply.

(ii) Result. Under section 6.03 of this notice, general limitation expenses reduce nondeductible CFC dividends after reducing other general limitation income, and the excess deductions constitute a separate limitation loss. Accordingly, prior to the application of section 904(f) USP has a (\$50) foreign source general limitation separate limitation loss, no general limitation nondeductible CFC dividends, and \$200 of U.S. source taxable income.

Example 4. Nondeductible CFC dividends exceed separate limitation income; separate limitation loss with U.S. and foreign source taxable income. (i) Facts. The facts are the same as in Example 3, except that instead of \$300 of U.S. source gross income USP has \$200 of U.S. source gross income and \$100 of foreign source passive gross income. Accordingly, USP has \$150 of taxable income and \$150 of nondeductible CFC dividends in the election year, and the taxable income limitation of section 965(e)(2)(A) does not apply.

(ii) Result. Under section 6.03 of this notice, general limitation expenses reduce nondeductible CFC dividends after reducing other general limitation income, and the excess deductions constitute a separate limitation loss. Accordingly, prior to the application of section 904(f) USP has a (\$50) foreign source general limitation separate limitation loss, no general limitation nondeductible CFC dividends, \$100 of foreign source passive taxable income, no passive limitation nondeductible CFC dividends, and \$100 of U.S. source taxable income.

SECTION 7. LIMITATION ON REDUCTION IN TAXABLE INCOME BELOW AMOUNT OF NONDEDUCTIBLE CFC DIVIDENDS PURSUANT TO SECTION 965(e)(2)

.01 *In General*

Under section 965(e)(2)(A), taxable income for the election year cannot be less than the amount of nondeductible CFC dividends received during such year. In addition, section 965(e)(2)(B)(i) provides that nondeductible CFC dividends are not taken into account under section 172 in determining the amount of any NOL for the election year. Accordingly, if deductible expenses and losses for the election year (including the DRD allowed under section 965(a) but not including expenses for which section 965(d)(2) disallows a deduction) exceed the taxpayer's gross income exclusive of the amount of nondeductible CFC dividends, taxable income will be equal to the amount of nondeductible CFC dividends, and the excess deductions will constitute an NOL for the taxable year. If, determined without regard to section 965(e)(2)(A), taxable income for the election year would be less than the amount of nondeductible CFC dividends received during such year, the excess of the deductions allocated and apportioned to a separate category over the amount of gross income in the separate category exclusive of the nondeductible CFC dividends will constitute a separate

limitation loss with respect to that separate category for the election year. Such separate limitation loss is allocated in accordance with section 904(f) and section 8 of this notice.

Section 965(e)(2)(B)(ii) provides that nondeductible CFC dividends are not taken into account in determining taxable income for the election year for purposes of the second sentence of section 172(b)(2), which applies in determining the allowable NOL carryover or carryback to that year. Therefore, the amount of the allowable NOL deduction for the election year is limited to the excess of taxable income over the amount of nondeductible CFC dividends. However, taxable income attributable to nondeductible CFC dividends is taken into account in determining the source and allocation of NOL deductions taken into account in the election year under paragraph 1 of Notice 89-3, 1989-1 C.B. 623.

.02 Examples

The following examples illustrate the application of section 965(e)(2) and this section 7.

Example 1. Taxable income limitation; one income category. (i) Facts. USP has the following items of gross income and expense for the election year: \$1,000 of foreign source general limitation gross income, including \$100 of qualifying dividends, and \$1,000 of deductible expenses allocated and apportioned to general limitation income (computed after the disallowance of expenses directly allocable to the deductible portion of the qualifying dividends), including the \$85 DRD allowed under section 965(a) and \$20 of expenses relating to nondeductible CFC dividends.

(ii) Result. Under section 965(e)(2)(A), USP's taxable income for the election year cannot be less than \$15, the amount of nondeductible CFC dividends received during such year. Because taxable income computed without regard to section 965(e)(2)(A) (\$0) is less than the amount of nondeductible CFC dividends (\$15), under section 7.01 of this notice the \$1,000 of general limitation expenses reduce general limitation income only to the extent of \$985 (\$1,000 - \$15), the excess of general

limitation gross income over general limitation nondeductible CFC dividends. Accordingly, USP has \$15 of general limitation taxable income, all attributable to nondeductible CFC dividends.

Under section 965(e)(2)(B)(i), the amount of USP's NOL for the election year is computed without regard to the \$15 of nondeductible CFC dividends. Accordingly, USP has general limitation taxable income of \$15 and a general limitation loss of (\$15) that constitutes a net operating loss of (\$15) for the election year.

Example 2. Taxable income limitation; U.S. and foreign source income. (i) Facts. The facts are the same as in Example 1, except that USP has \$1,500 rather than \$1,000 of deductible expenses allocated and apportioned to general limitation income, and also has \$1,000 of U.S. source gross income and \$500 of deductible expenses allocated and apportioned to U.S. source income.

(ii) Result. Under section 965(e)(2)(A), USP's taxable income for the election year cannot be less than \$15, the amount of nondeductible CFC dividends received during such year. Because taxable income computed without regard to section 965(e)(2)(A) (\$0) is less than the amount of nondeductible CFC dividends (\$15), under section 7.01 of this notice the \$1,500 of general limitation expenses reduce general limitation income only to the extent of \$985 (\$1,000 - \$15), the excess of general limitation gross income over general limitation nondeductible CFC dividends, and the \$515 (\$1,500 - \$985) excess of general limitation deductions over that amount constitutes a separate limitation loss. Accordingly, prior to the application of section 904(f) USP has \$15 of general limitation taxable income, all attributable to nondeductible CFC dividends, a general limitation separate limitation loss of (\$515), and U.S. source taxable income of \$500 (\$1,000 - \$500).

Under section 965(e)(2)(A), the amount of USP's NOL for the election year is computed without regard to the \$15 of nondeductible CFC dividends. Accordingly, USP has taxable income of \$15 and a net operating loss of (\$15) for the election year.

Example 3. Taxable income limitation; U.S. loss and foreign source income. (i) Facts. The facts are the same as in Example 2, except that instead of \$1,000 of U.S. source gross income USP has \$400 of U.S. source gross income and \$600 of foreign source passive gross income.

(ii) Result. Under section 965(e)(2)(A), USP's taxable income for the election year cannot be less than \$15, the amount of nondeductible CFC dividends received during such year. Because taxable income computed without regard to section 965(e)(2)(A) (\$0) is less than the amount of nondeductible CFC dividends (\$15), under section 7.01 of this notice the \$1,500 of general limitation expenses reduce general limitation income only to the extent of \$985 (\$1,000 - \$15), the excess of general limitation gross income over general limitation nondeductible CFC dividends, and the

\$515 (\$1,500 - \$985) excess of general limitation deductions over that amount constitutes a separate limitation loss. Accordingly, prior to the application of section 904(f) USP has \$15 of general limitation taxable income, all attributable to nondeductible CFC dividends, a general limitation separate limitation loss of (\$515), foreign source passive income of \$600, and U.S. source loss of (\$100) (\$400 - \$500).

Under section 965(e)(2)(A), the amount of USP's NOL for the election year is computed without regard to the \$15 of nondeductible CFC dividends. Accordingly, USP has taxable income of \$15 and a net operating loss of (\$15) for the election year.

Example 4. Net operating loss absorption. (i) Facts. Before taking into account the NOL deduction or applying section 904(f) in the election year, USP has \$100 of general limitation taxable income, all attributable to nondeductible CFC dividends, \$200 of passive limitation taxable income, and a \$100 NOL from prior years, all attributable to general limitation income.

(ii) Result. Because USP's available NOL (\$100) does not exceed the amount of taxable income exclusive of nondeductible CFC dividends for the election year (\$200), the net operating loss limitation of section 965(e)(2)(B)(ii) does not apply to limit USP's NOL deduction for the election year. Under section 965(e)(2)(B)(i) and section 7.01 of this notice, USP's \$100 of nondeductible CFC dividends is not taken into account in determining USP's allowable NOL deduction for the election year, but is taken into account in determining the source and allocation of NOL deductions absorbed in the election year. Accordingly, under paragraph (1)(b)(ii) of Notice 89-3, the \$100 general limitation NOL deduction reduces USP's \$100 of general limitation income to zero. After allocation of the NOL deduction but before application of section 904(f), USP has \$200 of passive limitation taxable income and no general limitation or passive limitation nondeductible CFC dividends in the election year.

Example 5. Net operating loss limitation. (i) Facts. Before taking into account the NOL deduction or applying section 904(f), USP has \$500 of general limitation foreign source taxable income, including \$15 of nondeductible CFC dividends, \$500 of passive limitation foreign source taxable income, and \$1,000 of U.S. source taxable income for the election year. USP also has a net operating loss carryover of \$2,000, consisting of \$1,000 of U.S. loss, \$600 of general limitation loss, and \$400 of passive limitation loss.

(ii) Result. Under section 965(e)(2)(B)(ii), USP's NOL deduction for the election year is limited to \$1,985, the amount of USP's taxable income exclusive of nondeductible CFC dividends. Under paragraph (1)(b)(i) of Notice 89-3, the \$1,000 U.S. loss component of the NOL carryover is absorbed first, and \$985 of the NOL carryover is available to offset foreign source income. Under paragraph (1)(b)(ii) of Notice 89-3, separate limitation losses that are part of the NOL carryover are tentatively carried over to the extent of separate limitation income in the same category. Pursuant

to section 965(e)(2)(B)(ii) and section 7.01 of this notice, the \$15 of nondeductible CFC dividends is not taken into account in determining the amount of the allowable NOL deduction, but is taken into account in determining the amount of general limitation income available to be absorbed by the allowable NOL. Accordingly, \$500 of the \$600 general limitation component of the NOL and \$400 of the passive limitation component of the NOL are tentatively carried over to the election year, eliminating the \$500 of general limitation income (including the \$15 of nondeductible CFC dividends) and \$400 of the \$500 of passive income.

Under paragraph (1)(b)(iii) of Notice 89-3, a proportionate part of the remaining loss from each separate limitation category is next carried over, to the extent of the remaining NOL carryover amount of \$85, and allocated in accordance with section 904(f)(5). Accordingly, an additional \$85 of the general limitation component of the NOL is carried over to the election year and allocated to passive income in accordance with section 904(f)(5). At the conclusion of these steps, USP has \$15 of passive income in the election year and a remaining NOL carryover to other years of (\$15), all attributable to general limitation loss.

.03 Other Deduction Limitations

For purposes of applying other Code provisions that contain limitations based on the amount of the taxpayer's gross income or taxable income for the taxable year, gross income includes qualifying dividends, and taxable income includes nondeductible CFC dividends.

.04 Examples

The following examples illustrate the application of section 7.03 of this notice.

Example 1. No taxable income limitation under section 965(e)(2)(A). (i) Facts. Before calculating its allowable charitable contribution deduction under section 170, USP has the following items of gross income and expense for the election year: \$1,000 of foreign source general limitation gross income, including \$200 of qualifying dividends, \$500 of deductible expenses allocated and apportioned to general limitation income (computed after the disallowance of expenses directly allocable to the deductible portion of the qualifying dividends), including the \$170 DRD allowed under section 965(a) and \$20 of expenses relating to nondeductible CFC dividends, \$1,000 of U.S. source gross income, and \$500 of deductible expenses allocated and apportioned to U.S. source income. Under section 7.01 of this notice, without regard to the charitable deduction USP has \$500 of general limitation taxable income, including \$30 of nondeductible CFC dividends, and \$500 of U.S. source taxable income for the election year.

(ii) Result. Section 170(b)(2), which limits a corporation's charitable contribution deduction to 10 percent of taxable income computed without regard to section 170 and certain other provisions not relevant on these facts, limits USP's allowable deduction to \$100, 10 percent of USP's taxable income of \$1000 for the election year. If USP claims the \$100 deduction, USP has \$900 of taxable income for the election year.

Example 2. Section 965(e)(2)(A) taxable income limitation. (i) Facts. Before calculating its allowable charitable contribution deduction under section 170, USP has the following items of gross income and expense for the election year: \$1,000 of foreign source general limitation gross income, including \$200 of qualifying dividends, and \$1,000 of deductible expenses allocated and apportioned to general limitation income (computed after the disallowance of expenses directly allocable to the deductible portion of the qualifying dividends), including the \$170 DRD allowed under section 965(a) and \$20 of expenses relating to nondeductible CFC dividends. Under sections 965(e)(2)(A) and 965(e)(2)(B)(i) and section 7.01 of this notice, without regard to the charitable contribution deduction, USP's current year deductions are limited to \$970 and USP has \$30 of general limitation taxable income, all attributable to nondeductible CFC dividends. Under section 965(e)(2)(B)(i) and section 7.01 of this notice, USP has a general limitation loss of \$30 that constitutes a net operating loss of \$30 for the election year.

(ii) Result. Section 170(b)(2), which limits a corporation's charitable contribution deduction to 10 percent of taxable income computed without regard to section 170 and certain other provisions not relevant on these facts, limits USP's allowable deduction to \$3, 10 percent of USP's taxable income of \$30 for the election year. If USP claims the \$3 deduction, USP has \$30 of taxable income and a \$33 NOL for the election year.

.05 No Other Limits on Use of Deductions to Reduce Taxable Income

Section 965(e)(2) limits the use of deductions to reduce taxable income below the amount of nondeductible CFC dividends, but does not restrict the use of deductions to offset income in excess of the amount of nondeductible CFC dividends. Therefore, deductions may offset income in excess of the amount of nondeductible CFC dividends, including income attributable to the section 78 gross-up that is required with respect to foreign taxes deemed paid with respect to nondeductible CFC dividends.

SECTION 8. OVERALL FOREIGN LOSS AND SEPARATE LIMITATION LOSS RULES

.01 In General

Section 965 does not modify the operation of the overall foreign loss and separate limitation loss allocation and recapture rules or the U.S. loss allocation rules of section 904(f). Accordingly, except in situations where the taxable income limitation of section 965(e)(2)(A) applies, as provided in paragraph .02 of this section, section 904(f) may operate to reduce amounts of foreign source income, which may include nondeductible CFC dividends in a separate category, or recharacterize such amount as U.S. source income or foreign source income in a different separate category for purposes of applying the limitations on the allowable foreign tax credit under sections 904(d) and 965(e)(1).

The amount of taxable income and the amount of the allowable NOL deduction for the election year are determined prior to the application of section 904(f). Therefore, the amount of the section 965(a) DRD, the amount of foreign taxes and expenses for which a credit or deduction is disallowed under section 965(d), the amount of taxable income determined under section 965(e)(2)(A), and the allowable NOL deduction determined under section 965(e)(2)(B) are not affected if nondeductible CFC dividends are reduced or recharacterized as U.S. source income or foreign source income in another separate category pursuant to section 904(f).

.02 Loss Allocation

To the extent a separate limitation loss or U.S. loss is allocated under section 904(f)(5)(B) or 904(f)(5)(D) to reduce foreign source taxable income in a separate

category that includes nondeductible CFC dividends, such loss will be considered first to reduce other foreign source income in the separate category before foreign source income attributable to nondeductible CFC dividends is reduced. Even if nondeductible CFC dividends are reduced as a result of a separate limitation loss or U.S. loss allocation, income in a later year in the separate category that is recharacterized under section 904(f)(5)(C) or section 904(f)(1) as income in the loss category or as U.S. source income, as the case may be, will not be considered nondeductible CFC dividends.

If the taxable income limitation of section 965(e)(2)(A) applies in the election year, taxable income equals the amount of nondeductible CFC dividends. In this case, after the allocation and apportionment of expenses and the determination and allocation of the allowable NOL deduction for the election year described in sections 6 and 7 of this notice, but prior to the application of section 904(f), a taxpayer may have separate limitation income attributable to nondeductible CFC dividends with or without a separate limitation loss in the same separate category, and may have separate limitation income or separate limitation losses in other separate categories as well as U.S. source taxable income or loss. Because separate limitation losses and U.S. losses in the aggregate may not reduce the sum of separate limitation income and U.S. source income below the amount of nondeductible CFC dividends in the election year, the excess of such losses over the amount of such income exclusive of the amount of nondeductible CFC dividends will constitute a net operating loss for the election year. For purposes of determining which losses are absorbed in the election year and which losses make up

the net operating loss in the election year if the taxable income limitation of section 965(e)(2) applies, separate limitation losses and U.S. losses are allocated under section 904(f)(5)(B) and (D) without regard to nondeductible CFC dividends. See Examples 3 and 4 in section 8.05 of this notice.

.03 Loss Recapture

After separate limitation losses for the taxable year are allocated to reduce separate limitation income in other separate categories, any remaining separate limitation income may be recharacterized as income in another separate category or as U.S. source income, if the taxpayer had separate limitation losses in that same separate category in a prior taxable year that were allocated to reduce separate limitation income in that other separate category or U.S. source income. This recharacterization of income operates to recapture the prior year separate limitation loss or overall foreign loss. See section 904(f)(1), section 904(f)(5)(C), and Notice 89-3. Separate limitation losses and overall foreign losses may be recaptured in the election year out of income in any separate category with separate limitation income, including income attributable to nondeductible CFC dividends, whether or not the taxable income limitation of section 965(e)(2)(A) applies in the election year.

Separate limitation losses and overall foreign losses with respect to a separate category that includes nondeductible CFC dividends will be considered recaptured first out of other income in the separate category before any income attributable to nondeductible CFC dividends is recharacterized. See Example 5 in section 8.05 of this notice. If nondeductible CFC dividends are recharacterized as U.S. source income or

income in a different separate category, the recharacterized income is not treated as nondeductible CFC dividends. See Examples 6 and 7 in section 8.05 of this notice.

.04 Treatment of Foreign Taxes Imposed with Respect to Nondeductible CFC

Dividends

The recharacterization of income under the overall foreign loss or separate limitation loss recapture rules does not result in the recharacterization of any tax. Section 904(f)(5)(C). Accordingly, foreign tax attributable to nondeductible CFC dividends in a separate category remains in that separate category even if the income attributable to the nondeductible CFC dividends is recharacterized. See section 9.02 of this notice for rules relating to the application of section 965(e)(1) to foreign taxes attributable to nondeductible CFC dividends when a portion of nondeductible CFC dividends is recharacterized under section 904(f) and this section 8.

.05 Examples

The following examples illustrate the application of the rules of section 904(f) and this section 8.

Example 1. No taxable income limitation; allocation of separate limitation loss.

(i) Facts. After the allocation and apportionment of expenses but before the application of section 904(f), USP has the following items of taxable income for the election year: \$100 of general limitation income, all attributable to nondeductible CFC dividends, (\$100) of passive limitation loss, and \$200 of U.S. source taxable income.

(ii) Result. Because USP's taxable income in the election year (\$200) exceeds the amount of nondeductible CFC dividends (\$100), the taxable income limitation of section 965(e)(2)(A) does not apply. Under section 904(f)(5)(B), paragraph (2) of Notice 89-3, and section 8.02 of this notice, USP's \$100 passive limitation loss is allocated to reduce the \$100 of general limitation income to zero. After allocation of the separate limitation loss, USP has no general limitation or passive income, no general limitation or passive limitation nondeductible CFC dividends, and \$200 of U.S. source taxable income. USP has a passive limitation loss recapture account of \$100 with respect to

general limitation income.

Example 2. Taxable income limitation; allocation of separate limitation loss. (i) Facts. The facts are the same as in Example 1, except that USP has \$40, rather than \$200, of U.S. source taxable income in the election year.

(ii) Result. Because USP's taxable income computed without regard to section 965(e)(2)(A) (\$40) is less than the amount of nondeductible CFC dividends (\$100), the taxable income limitation of section 965(e)(2)(A) applies. Therefore, under section 8.02 of this notice the loss allocation rules of section 904(f)(5) and Notice 89-3 are applied without regard to the nondeductible CFC dividends. Accordingly, under section 904(f)(5)(A) and section 8.02 of this notice \$40 of USP's \$100 passive limitation loss is allocated to reduce U.S. source taxable income to zero, and the remaining \$60 passive loss constitutes an NOL for the election year. After allocation of the separate limitation loss, USP has \$100 of general limitation income, all attributable to nondeductible CFC dividends, a \$60 passive limitation loss that constitutes an NOL, and no U.S. source taxable income. USP has a \$40 overall foreign loss account in the passive category.

Example 3. Taxable income limitation; allocation of U.S. loss. (i) Facts. After the allocation and apportionment of expenses but before the application of section 904(f), USP has the following items of taxable income for the election year: \$750 of general limitation income, of which \$500 is attributable to nondeductible CFC dividends, and \$750 of U.S. source loss.

(ii) Result. Because USP's taxable income computed without regard to section 965(e)(2)(A) (\$0) is less than the amount of nondeductible CFC dividends (\$500), the taxable income limitation of section 965(e)(2)(A) applies. Therefore, under section 8.02 of this notice the loss allocation rules of section 904(f)(5) and Notice 89-3 are applied without regard to the nondeductible CFC dividends. Accordingly, under section 904(f)(5)(D) and section 8.02 of this notice \$250 of USP's \$750 U.S. loss is allocated to reduce general limitation income to \$500, and the remaining \$500 U.S. loss constitutes an NOL for the election year. After allocation of the U.S. loss, USP has \$500 of general limitation income, all attributable to nondeductible CFC dividends, and a \$500 U.S. loss that constitutes an NOL.

Example 4. Taxable income limitation; allocation of separate limitation loss and U.S. loss. (i) Facts. After the allocation and apportionment of expenses but before the application of section 904(f), USP has the following items of taxable income for the election year: \$100 of general limitation income attributable to nondeductible CFC dividends, (\$100) of general limitation loss, \$100 of passive income, and (\$100) of U.S. source loss.

(ii) Result. Because USP's taxable income computed without regard to section 965(e)(2)(A) (\$0) is less than the amount of nondeductible CFC dividends (\$100), the

taxable income limitation of section 965(e)(2)(A) applies. Therefore, under section 8.02 of this notice the loss allocation rules of section 904(f)(5) and Notice 89-3 are applied without regard to the nondeductible CFC dividends. Accordingly, under section 904(f)(5)(B) and section 8.02 of this notice USP's \$100 general limitation loss is allocated to reduce passive income to zero, and the \$100 U.S. loss constitutes an NOL for the election year. After allocation of the separate limitation loss, USP has \$100 of general limitation income, all attributable to nondeductible CFC dividends, and a \$100 U.S. loss that constitutes an NOL. USP has a \$100 general limitation loss recapture account with respect to passive income.

Example 5. OFL recapture from other income. (i) Facts. After the allocation and apportionment of expenses but before the application of section 904(f), USP has the following items of taxable income for the election year: \$150 of general limitation income attributable to nondeductible CFC dividends and \$190 of other general limitation income. USP has a pre-2005 general limitation OFL account of \$400.

(ii) Result. Under section 904(f)(1), 50 percent or \$170 of USP's general limitation income is recharacterized as U.S. source income. Since the recapture amount does not exceed USP's foreign source general limitation income exclusive of nondeductible CFC dividends, after OFL recapture USP has \$150 of nondeductible CFC dividends and \$20 of other income in the general limitation category, and \$170 of U.S. source income. USP's general limitation OFL recapture account is reduced by \$170.

Example 6. OFL recapture from nondeductible CFC dividends. (i) Facts. After the allocation and apportionment of expenses but before the application of section 904(f), USP has the following items of taxable income for the election year: \$150 of general limitation income, all attributable to nondeductible CFC dividends. USP has a pre-2005 general limitation OFL account of \$200.

(ii) Result. Under section 904(f)(1), unless USP elects to recapture a larger percentage of the OFL account, 50 percent or \$75 of USP's general limitation income is recharacterized as U.S. source income. After OFL recapture USP has \$75 of nondeductible CFC dividends in the general limitation category, and \$75 of U.S. source income. USP's OFL recapture account is reduced by \$75.

Example 7. Separate limitation loss recapture from nondeductible CFC dividends. (i) Facts. After the allocation and apportionment of expenses but before the application of section 904(f), USP has the following items of taxable income for the election year: \$240 of general limitation income, of which \$150 is attributable to nondeductible CFC dividends. USP has a general limitation separate limitation loss recapture account with respect to passive income of \$200.

(ii) Result. Since the \$200 recapture amount exceeds \$90, USP's foreign source general limitation income exclusive of nondeductible CFC dividends (\$240 -

\$150), a portion of the nondeductible CFC dividends is recaptured after all other general limitation income is recaptured under section 904(f)(5)(C). Accordingly, \$200 of USP's general limitation income, equal to \$90 of other income plus \$110 of nondeductible CFC dividends, is recharacterized as passive income. After recapture of the separate limitation loss, USP has \$40 of general limitation income, all attributable to nondeductible CFC dividends, and \$200 of passive income. USP's general limitation separate limitation loss recapture account with respect to passive income is reduced by \$200 to 0.

SECTION 9. RESTRICTION ON USE OF CREDITS TO OFFSET TAX ON NONDEDUCTIBLE CFC DIVIDENDS AND COMPUTATION OF ALTERNATIVE MINIMUM TAX PURSUANT TO SECTION 965(e)(1)

.01 In General

Section 965(e)(1) provides that tax on nondeductible CFC dividends is not treated as a tax when determining the amount of any allowable credit or the amount of alternative minimum tax imposed by section 55. However, this rule does not apply to the credit under section 53 for prior year minimum tax, or to the credit under section 27(a) for foreign taxes attributable to nondeductible CFC dividends. Therefore, the portion of the pre-credit U.S. tax that is attributable to the nondeductible CFC dividends may not be offset by any credit other than prior year minimum tax credits and a foreign tax credit for foreign taxes attributable to the nondeductible CFC dividends.

.02 Additional Limitation on Foreign Tax Credits

(a) *In general.* The limitation under section 965(e) on the use of foreign tax credits against the U.S. tax on nondeductible CFC dividends (the section 965(e) limitation) is implemented through an additional foreign tax credit limitation for each separate category that includes nondeductible CFC dividends. Section 965 does not

provide for a distinct separate category for qualifying dividends. Instead, qualifying dividends are characterized as income in separate categories under the generally applicable look-through rules of sections 904(d)(3)(B) and 904(d)(3)(D). See sections 3.02 and 6.01 of this notice. The section 965(e) limitation is applied after gross income and deductible expenses, including the NOL deduction, are allocated and apportioned to determine U.S. source taxable income and foreign source taxable income in the separate categories, as described in sections 6 and 7 of this notice, after the allocation of separate limitation losses, overall foreign losses, and U.S. losses and the recapture of overall foreign losses and separate limitation losses pursuant to section 904(f), as described in section 8 of this notice, and after computing the regular section 904 limitation for each separate category that contains nondeductible CFC dividends.

The section 965(e) limitation for any separate category equals the sum of (i) the creditable foreign taxes paid or accrued with respect to the nondeductible CFC dividends in the separate category and (ii) the modified section 904 limitation for that separate category. The modified section 904 limitation for a separate category is calculated by subtracting the amount of nondeductible CFC dividends in the separate category from both the numerator and denominator of the regular section 904 limitation fraction and subtracting the pre-credit U.S. tax attributable to the nondeductible CFC dividends in the separate category from the pre-credit U.S. tax used in the regular section 904 limitation calculation. See Examples 1 through 4 of section 9.02(c) of this notice. For this purpose, the pre-credit U.S. tax attributable to the nondeductible CFC dividends in the separate category equals 35 percent (20 percent for alternative

minimum tax purposes) of the amount of nondeductible CFC dividends in the separate category.

For purposes of applying the section 965(e) limitation to a separate category that included nondeductible CFC dividends that were reduced by deductions or recharacterized as U.S. source income or income in a different separate category pursuant to sections 6 and 8 of this notice and section 904(f), the amount of nondeductible CFC dividends in the separate category is the portion, if any, of the nondeductible CFC dividends that was not reduced by deductions or recharacterized, and the amount of foreign tax attributable to the nondeductible CFC dividends is the portion of the foreign taxes paid with respect to nondeductible CFC dividends that are attributable to such reduced amount.

The applicable foreign tax credit limitation for each separate category is the smaller of the regular section 904 limitation or the section 965(e) limitation, and the allowable foreign tax credit for each separate category is the smaller of the foreign taxes in the separate category or the applicable foreign tax credit limitation. In effect, the section 965(e) limitation will reduce the otherwise allowable foreign tax credit only if nondeductible CFC dividends are considered to bear a lower effective rate of foreign tax than other income in the same separate category and the other income is effectively taxed in excess of the U.S. rate. In this situation, section 965(e)(1) is intended to prevent the excess credits associated with the other income from reducing the U.S. tax on the nondeductible CFC dividends. See Example 4 in section 9.02(c) of this notice.

(b) No Limitation on Use of Foreign Tax Credits against U.S. Tax on Income

Other than Nondeductible CFC Dividends. Section 965(e)(1) does not restrict the use of foreign tax credits, including credits for foreign taxes paid or deemed paid with respect to nondeductible CFC dividends, to reduce the U.S. tax on income other than nondeductible CFC dividends. Therefore, to the extent otherwise allowable, foreign tax credits for foreign taxes paid with respect to nondeductible CFC dividends or other income may reduce the U.S. tax on other foreign source taxable income, including income attributable to the section 78 gross-up for foreign taxes deemed paid with respect to nondeductible CFC dividends.

(c) *Examples.* The following examples illustrate the application of section 965(e)(1) and this section 9.02.

Example 1. All Low-Taxed Income. (i) Facts. USP wholly owns CFC1 and CFC2 and elects to apply section 965 to its 2005 calendar tax year. As of the close of 2005, CFC1 has post-1986 undistributed earnings and post-1986 foreign income taxes of \$1,000x and \$100x, respectively, and CFC2 has post-1986 undistributed earnings and post-1986 foreign income taxes of \$1,000x and \$200x, respectively. All post-1986 undistributed earnings of CFC1 and CFC2 are general limitation earnings and profits, and neither CFC1 nor CFC2 has any previously-taxed earnings and profits described in sections 959(c)(1) or 959(c)(2). USP's base period amount is \$100x, and the requirements of section 965 are met for the election year. CFC1 distributes a cash dividend of \$1,000x resulting in deemed-paid taxes of \$100x ($(\$1,000x/\$1,000x) \times \$100x$), CFC2 distributes a cash dividend of \$100x resulting in deemed-paid taxes of \$20x ($(\$100x/\$1,000x) \times \$200x$), and USP accrues no other items of income or expense in the election year. USP identifies the lower-taxed cash dividend from CFC1 as the qualifying dividend.

(ii) Result. Step 1. Determine creditable foreign taxes. USP is entitled to an \$850x DRD under section 965(a) with respect to the \$1,000x qualifying dividend from CFC1, and has \$150x of nondeductible CFC dividends. Under section 965(d)(1) and section 4.01 of this notice, USP may claim a credit for \$15x ($.15 \times \$100x$) of deemed-paid foreign tax attributable to the nondeductible CFC dividend. Because no section 965 DRD is allowed with respect to the \$100x dividend from CFC2, all \$100x is taxed, and all \$20x of deemed-paid tax attributable to the CFC2 dividend is creditable. Thus, USP's creditable foreign taxes, prior to the application of the limitation rules, are \$35x ($\$15x + \$20x$), and USP includes \$35x in income under section 78.

Step 2. Determine regular section 904 limitation. Total foreign source taxable income (FSTI) equals \$285x (\$1,000x CFC1 dividend - \$850x DRD + \$100x CFC2 dividend + \$35x gross-up). Because USP has no other income, worldwide taxable income (WWTI) is also \$285x. USP's pre-credit U.S. tax is \$99.75x (.35 x \$285x). The regular section 904 limitation is \$99.75x ($(\$285x \text{ FSTI} / \$285x \text{ WWTI}) \times \$99.75x$). Thus, all \$35 of foreign taxes are eligible for the credit under the regular section 904 limitation.

Step 3. Determine section 965(e) limitation. Pursuant to this section 9.02, the section 965(e) limitation is the sum of the creditable foreign taxes paid or accrued with respect to the nondeductible CFC dividends and the modified section 904 limitation that results from subtracting the amount of the nondeductible CFC dividends from the numerator and denominator of the regular section 904 limitation fraction and subtracting the pre-credit U.S. tax on the nondeductible CFC dividends from the pre-credit U.S. tax in the regular section 904 limitation. The foreign taxes on the \$150x of nondeductible CFC dividends are \$15x. Subtracting the \$150 of nondeductible CFC dividends from the numerator and denominator of the regular section 904 limitation fraction, USP has \$135x of other FSTI and WWTI (\$100x CFC2 dividend plus \$35x of gross-up income) and a pre-credit U.S. tax on this amount of \$47.25x ($\$99.75x - (.35 \times \$150x)$). The modified section 904 limitation equals \$47.25x ($(\$135x \text{ FSTI} / \$135x \text{ WWTI}) \times \$47.25x$). The section 965(e) limitation equals \$62.25x ($\$15x + \$47.25x$). Because the total amount of creditable foreign taxes is less than both the section 965(e) limitation and the regular section 904 limitation, USP may credit all \$35x of foreign tax in the election year.

Example 2. All High-Taxed Income. (i) Facts. The facts are the same as in Example 1, except that CFC1 has post-1986 undistributed earnings and post-1986 foreign income taxes of \$1,000x and \$600x, respectively, and CFC2 has post-1986 undistributed earnings and post-1986 foreign income taxes of \$1,000x and \$750x, respectively. Accordingly, the \$1,000x dividend from CFC1 results in foreign taxes deemed paid of \$600x ($(\$1,000x / \$1,000x) \times \$600x$), and the \$100x dividend from CFC2 results in foreign taxes deemed paid of \$75x ($(\$100x / \$1,000x) \times \$750x$).

(ii) Result. Step 1. Determine creditable foreign taxes. USP is entitled to an \$850x DRD under section 965(a) with respect to the \$1,000x qualifying dividend from CFC1, and has \$150 of nondeductible CFC dividends. Under section 965(d)(1) and section 4.01 of this notice, USP may claim a credit for \$90x ($.15 \times \$600x$) of deemed-paid foreign tax attributable to the nondeductible CFC dividend. Because no section 965 DRD is allowed with respect to the \$100x dividend from CFC2, all \$100x is taxed, and all \$75x of deemed-paid tax attributable to the CFC2 dividend is creditable. Thus, USP's creditable foreign taxes, prior to the application of the limitation rules, are \$165x ($\$90x + \$75x$), and USP includes \$165x in income under section 78.

Step 2. Determine regular section 904 limitation. USP's FSTI equals \$415x (\$1,000x qualifying dividend from CFC1 - \$850x DRD + \$100x dividend from CFC2 + \$165x gross-up). Because USP has no other income, WWTI is also \$415x. USP's pre-credit U.S. tax is \$145.25x (.35 x \$415x). Thus, the limitation equals \$145.25x ((\$415x FSTI/\$415x WWTI) x \$145.25x). Because the limitation is less than the total creditable taxes of \$165x, the regular section 904 limitation prevents the excess \$19.75x from being credited in the current year.

Step 3. Determine section 965(e) limitation. The foreign taxes on the \$150x of nondeductible CFC dividends are \$90x. Subtracting the \$150x of nondeductible CFC dividends from the numerator and denominator of the regular section 904 limitation fraction, USP has \$265x of other FSTI and WWTI (\$415x - \$150x) and a pre-credit U.S. tax on this amount of \$92.75x (\$145.25x - (.35 x \$150x)). The modified section 904 limitation equals \$92.75x ((\$265x FSTI/\$265x WWTI) x \$92.75x). The section 965(e) limitation equals \$182.75x (\$90x + \$92.75x). Because the section 965(e) limitation is higher than the regular section 904 limitation, the total amount of creditable foreign taxes are subject to the regular section 904 limitation of \$145.25x.

Example 3. High-Taxed Nondeductible CFC Dividend/Low-Taxed Other Income.

(i) Facts. The facts are the same as in Example 1, except that CFC1 has post-1986 undistributed earnings and post-1986 foreign income taxes of \$1,000x and \$400x, respectively, CFC2 does not pay a dividend in the election year, and USP has an additional \$100x of general limitation income subject to no foreign tax. Accordingly, the \$1,000x dividend from CFC1 results in foreign taxes deemed paid of \$400x ((\$1,000x/\$1,000x) x \$400x), and no foreign taxes of CFC2 are deemed paid in the election year.

(ii) Result. Step 1. Determine creditable foreign taxes. USP is entitled to an \$850x DRD under section 965(a) with respect to the \$1,000x qualifying dividend from CFC1, and has \$150x of nondeductible CFC dividends. Under section 965(d)(1) and section 4.01 of this notice, USP may claim a credit for \$60x (.15 x \$400x) of deemed-paid foreign tax attributable to the nondeductible CFC dividend. Thus, USP's creditable foreign taxes, prior to the application of the limitation rules, are \$60x, and USP includes \$60x in income under section 78.

Step 2. Determine regular section 904 limitation. USP's FSTI equals \$310x (\$1,000x qualifying dividend from CFC1 - \$850x DRD + \$60x gross-up + \$100x of other income). Because USP has no other income, WWTI is also \$310x. USP's pre-credit U.S. tax is \$108.50x (.35 x \$310x). Thus, the regular section 904 limitation equals \$108.50x ((\$310x FSTI/\$310x WWTI) x \$108.50x). All \$60x of foreign tax would be creditable, because the foreign taxes paid in excess of the U.S. tax on the nondeductible CFC dividend can reduce the U.S. tax on the gross-up income and the other foreign source income.

Step 3. Determine section 965(e) limitation. The foreign taxes on the \$150x of nondeductible CFC dividends are \$60x. Subtracting the \$150x of nondeductible CFC dividends from the numerator and denominator of the regular section 904 limitation fraction, USP has \$160x of other FSTI and WWTI ($\$310x - \$150x$) and a pre-credit U.S. tax on this amount of \$56x ($\$108.50x - (.35 \times \$150x)$). The modified section 904 limitation equals \$56x ($(\$160x \text{ FSTI}/\$160x \text{ WWTI}) \times \$56x$). The section 965(e) limitation equals \$116x ($\$60x + \$56x$). Because the section 965(e) limitation is higher than the regular section 904 limitation, the \$60x total amount of creditable foreign taxes are subject to the regular section 904 limitation of \$108.50x, and the excess foreign taxes on the nondeductible CFC dividend can reduce the U.S. tax on USP's other foreign source income.

Example 4. Low-Taxed Nondeductible CFC Dividend/High-Taxed Other Income.

(i) Facts. The facts are the same as in Example 1, except that CFC2 has post-1986 undistributed earnings and post-1986 foreign income taxes of \$1,000x and \$750x, respectively. Accordingly, the \$1,000x dividend from CFC1 results in foreign taxes deemed paid of \$100x ($(\$1,000x/\$1,000x) \times \$100x$), and the \$100x dividend from CFC2 results in foreign taxes deemed paid of \$75x ($(\$100x/\$1,000x) \times \$750x$).

(ii) Result. Step 1. Determine creditable foreign taxes. USP is entitled to an \$850x DRD under section 965(a) with respect to the \$1,000x qualifying dividend from CFC1, and has \$150x of nondeductible CFC dividends. Under section 965(d)(1) and section 4.01 of this notice, USP may claim a credit for \$15x ($.15 \times \$100x$) of deemed-paid foreign tax attributable to the nondeductible CFC dividend. Because no section 965 DRD is allowed with respect to the \$100x dividend from CFC2, all \$100x is taxed, and all \$75x of deemed-paid tax attributable to the CFC2 dividend is creditable. Thus, USP's creditable foreign taxes, prior to the application of the limitation rules, are \$90x ($\$15x + \$75x$), and USP includes \$90x in income under section 78.

Step 2. Determine regular section 904 limitation. USP's FSTI equals \$340x ($\$1,000x \text{ qualifying dividend from CFC1} - \$850x \text{ DRD} + \$100x \text{ dividend from CFC2} + \$90x \text{ gross-up}$). Because USP has no other income, WWTI is also \$340x. USP's pre-credit U.S. tax is \$119x ($.35 \times \$340x$). Thus, the regular section 904 limitation equals \$119x ($(\$340x \text{ FSTI}/\$340x \text{ WWTI}) \times \$119x$). The regular section 904 limitation would allow all \$90x of foreign tax to be credited, because the foreign taxes paid in excess of the U.S. tax on the CFC2 dividend could reduce the U.S. tax on the low-taxed nondeductible CFC dividend from CFC1.

Step 3. Determine section 965(e) limitation. The foreign taxes on the \$150x of nondeductible CFC dividends are \$15x. Subtracting the \$150x of nondeductible CFC dividends from the numerator and denominator of the regular section 904 limitation fraction, USP has \$190x of other FSTI and WWTI ($\$340x - \$150x$) and a pre-credit U.S. tax on this amount of \$66.50x ($\$119x - (.35 \times \$150x)$). The modified section 904 limitation equals \$66.50x ($(\$190x \text{ FSTI}/\$190x \text{ WWTI}) \times \$66.50x$). The section 965(e)

limitation equals \$81.50x (\$15x + \$66.50x). Because the section 965(e) limitation is less than the regular section 904 limitation of \$119x, the section 965(e) limitation applies and prevents USP from crediting \$8.50x of the \$90x of potentially creditable taxes. The \$8.50x of tax which is not creditable under the section 965(e) limitation equals the excess foreign taxes on the other foreign source income that would have been creditable against the U.S. tax on the nondeductible CFC dividend under the regular section 904 limitation (i.e., the excess of the \$75x of foreign tax on the CFC2 dividend over \$66.50x, the pre-credit U.S. tax on \$190x of other foreign source income (\$100x CFC2 dividend + \$75x gross-up attributable to tax deemed paid on the CFC2 dividend + \$15x gross-up attributable to the nondeductible CFC dividend from CFC1)). The excess taxes may be carried over and used as a credit in other years to the extent allowed under section 904(c).

.03 No Use of Credits Other than Credit for Prior Year Minimum Tax to Offset U.S. Tax on Nondeductible CFC Dividends

Section 965(e)(1) provides that no credit other than a foreign tax credit for foreign taxes attributable to nondeductible CFC dividends and the credit for prior year minimum tax under section 53 may offset the U.S. tax on nondeductible CFC dividends.

However, section 965 does not limit the application of credits against the U.S. tax on income other than nondeductible CFC dividends. Because other credits, including the possessions tax credit allowed under sections 27(b) and 30A, the nonconventional source fuel credit allowed under section 29, the qualified electric vehicle credit allowed under section 30, and the general business credit allowed under section 38, as well as the credit for prior year minimum tax that is allowed under section 53, are applied after the foreign tax credit, taxpayers must identify the portion of their pre-credit U.S. tax and allowable foreign tax credit for the election year that is attributable to nondeductible CFC dividends and the portion that is attributable to other income in order to determine the amount of their other allowable credits.

For purposes of this determination and section 9.05 of this notice, the portion of a taxpayer's pre-credit U.S. tax that is attributable to nondeductible CFC dividends equals the smaller of the taxpayer's total pre-credit U.S. tax or 35 percent of the amount of nondeductible CFC dividends. For this purpose, the amount of nondeductible CFC dividends is the amount determined under section 965(e)(3), without regard to any reduction or recharacterization of nondeductible CFC dividends in a separate category for purposes of determining the foreign tax credit limitation as provided in sections 6 through 8 of this notice. The portion of the taxpayer's pre-credit U.S. tax that is attributable to other income equals the excess, if any, of the taxpayer's total pre-credit U.S. tax over the pre-credit U.S. tax attributable to nondeductible CFC dividends. To determine the total allowable foreign tax credit for the election year, the taxpayer must first compute the allowable credit for each separate category, applying the section 965(e) limitation described in section 9.02 of this notice. The portion of the taxpayer's allowable foreign tax credit in each separate category that is attributable to nondeductible CFC dividends equals the smaller of 35 percent of the amount of nondeductible CFC dividends in the separate category, determined after applying sections 6 through 8 of this notice, or the foreign taxes paid or accrued with respect to the nondeductible CFC dividends in that separate category, determined in accordance with section 9.02(a) of this notice. The portion of the allowable foreign tax credit that is attributable to nondeductible CFC dividends is the sum of the amounts determined under the preceding sentence in all of the taxpayer's separate categories. The remainder, if any, of the allowable foreign tax credit is considered attributable to other

income.

The taxpayer's residual U.S. tax on nondeductible CFC dividends, as reduced by the portion of the allowable foreign tax credit that is attributable to that income, may not be reduced by any credit other than the prior year minimum tax credit. The taxpayer's residual U.S. tax on other income, as reduced by the balance of the allowable foreign tax credit, may be reduced by other credits in accordance with the rules generally applicable to such credits.

.04 Computation of Section 53 Credit in Election Year

Under section 965(e)(1), the U.S. tax on nondeductible CFC dividends is taken into account in determining the allowable amount of prior year minimum tax credits under section 53 for the election year. Accordingly, for purposes of section 53 the taxpayer's regular tax and tentative minimum tax are computed taking into account the regular tax and tentative minimum tax on nondeductible CFC dividends, as reduced by allowable foreign tax credits computed in accordance with section 965(e)(1) and section 9.02 of this notice. As a result, credits for prior year minimum tax may be allowed in the election year to reduce the regular tax on nondeductible CFC dividends and other income, subject to the limitation of section 53(c), even if the taxpayer's entire taxable income is attributable to nondeductible CFC dividends or if the taxpayer is subject to AMT on taxable income other than nondeductible CFC dividends in the election year. See Examples 3 through 6 of section 9.06 of this notice.

.05 Computation of Alternative Minimum Tax in Election Year

Section 965(e)(1) provides that the U.S. tax on nondeductible CFC dividends is

not treated as tax imposed by chapter 1 for purposes of computing the AMT imposed by section 55. For purposes of computing AMT for the election year, the taxpayer's regular tax described in section 55(c) does not include the portion of the taxpayer's pre-credit regular tax liability that is attributable to nondeductible CFC dividends, and the foreign tax credit taken into account does not include the portion of the taxpayer's allowable foreign tax credit that is attributable to nondeductible CFC dividends. Similarly, the taxpayer's tentative minimum tax determined under section 55(b)(1)(B) does not include the portion of the taxpayer's tentative minimum tax or alternative minimum tax foreign tax credit that is attributable to nondeductible CFC dividends. In addition, the deductible portion of qualifying dividends is not treated as a preference item in computing alternative minimum taxable income. Accordingly, the additional tax owed by the taxpayer by reason of the AMT in the election year is the same that would be owed if the qualifying dividends were not paid. See Examples 1, 2, 4 and 5 of section 9.06 of this notice.

.06 Examples

The following examples illustrate the application of section 965(e)(1) and sections 9.04 and 9.05 of this notice.

Example 1. Calculation of AMT with no foreign tax credit. (i) Facts. For the election year USP's taxable income consists of \$200x of foreign source general limitation nondeductible CFC dividends subject to no foreign tax and \$400x of U.S. source income. USP's pre-credit regular tax liability is \$210x ($.35 \times \$600x$). USP has \$600x of U.S. source preference items.

(ii) Result. Taking into account the adjustments required by section 965(e)(1)(B) for purposes of computing USP's alternative minimum tax under section 55 in the election year, USP's taxable income computed without regard to the \$200x of nondeductible CFC dividends is \$400x, which would result in a pre-credit regular tax

liability of \$140x ($.35 \times \$400x$). USP's alternative minimum taxable income computed without regard to the \$200x of nondeductible CFC dividends is increased by \$600x of preference items from \$400x to \$1,000x. USP's tentative minimum tax, computed without regard to the nondeductible CFC dividends, is \$200x ($.20 \times \$1,000x$). The excess of USP's adjusted tentative minimum tax of \$200x over its adjusted regular tax of \$140x results in alternative minimum tax of \$60x. USP's pre-credit tax for the election year is \$270x (\$210x of regular tax plus \$60x of alternative minimum tax). This amount is equivalent to 20 percent of \$1,000x, USP's alternative minimum taxable income exclusive of the nondeductible CFC dividends, plus 35 percent of \$200x of nondeductible CFC dividends.

Example 2. Alternative minimum tax foreign tax credit. (i) Facts. The facts are the same as in Example 1, except that instead of \$400x of U.S. source income, USP has \$200x of U.S. source income and \$200x of other foreign source general limitation income, and USP's foreign taxes paid or deemed paid with respect to general limitation income are \$100x, including \$20x of foreign tax paid or accrued with respect to the \$200x of nondeductible CFC dividends.

(ii) Result. As in Example 1, USP's pre-credit regular tax on \$400x of taxable income in excess of the \$200x of nondeductible CFC dividends is \$140x and its pre-credit tentative minimum tax on \$1,000x of alternative minimum taxable income in excess of the nondeductible CFC dividends (\$400x plus \$600x of preference items) is \$200x. USP's allowable foreign tax credit computed for regular tax purposes is \$90x, the lesser of \$100x, the foreign taxes paid, \$140x, the regular section 904 limitation ($(\$400x \text{ FSTI}/\$600x \text{ WWTI}) \times \$210x \text{ pre-credit U.S. tax}$), or \$90x, the section 965(e) limitation ($\$20x \text{ foreign tax on nondeductible CFC dividends} + \$70x, \text{ the limitation on other income of } (\$200x \text{ FSTI}/\$400x \text{ WWTI}) \times \$140x$). The portion of the allowable regular foreign tax credit that is attributable to the nondeductible CFC dividends is \$20x, the smaller of the \$70x pre-credit U.S. tax on the nondeductible CFC dividends ($.35 \times \$200x$) or \$20x, the foreign taxes paid or accrued with respect to the nondeductible CFC dividends. The remaining \$70x of the allowable regular foreign tax credit is the amount attributable to USP's other foreign source income. Accordingly, USP's regular tax described in section 55(c), computed without regard to the tax on nondeductible CFC dividends, is \$70x (\$140x regular tax - \$70x foreign tax credit).

Computed without regard to section 965(e)(1)(B), USP's alternative minimum tax foreign tax credit is \$60x, the lesser of \$100x, the foreign taxes paid, \$80x, the regular alternative minimum tax foreign tax credit limitation ($(\$400x \text{ FSAMTI}/\$1200x \text{ WWAMTI}) \times \$240x$), or \$60x, the section 965(e) limitation ($\$20x + (\$200x \text{ FSAMTI}/\$1000x \text{ WWAMTI}) \times \$200x$). The portion of the alternative minimum tax foreign tax credit that is attributable to nondeductible CFC dividends is \$20x, the lesser of \$40x, the pre-credit U.S. alternative minimum tax on the nondeductible CFC dividends ($.20 \times \$200x$) or \$20x, the foreign taxes paid or accrued with respect to the nondeductible CFC dividends. The \$40x balance of the alternative minimum tax foreign tax credit is

attributable to USP's other foreign source income.

Accordingly, USP's tentative minimum tax described in section 55(b)(1)(B), computed without regard to the tax on nondeductible CFC dividends, is \$160x ($\$200x - \$40x$). Under section 55 as modified by section 965(e)(1)(B), USP's alternative minimum tax is \$90x, the excess of its tentative minimum tax over its regular tax ($\$160x - \$70x$). Accordingly, USP's tax for the election year is \$210x ($\$210x$ regular tax on \$600x of taxable income - \$90x regular foreign tax credit + \$90x alternative minimum tax). This amount is equivalent to 20 percent of USP's \$1,000x of alternative minimum taxable income exclusive of the nondeductible CFC dividends less the \$40x alternative minimum tax foreign tax credit on that amount ($\$200x - \$40x$), plus 35 percent of \$200x of nondeductible CFC dividends less the \$20x regular foreign tax credit on that amount ($\$70x - \$20x$).

Example 3. No AMT; prior year minimum tax credit. (i) Facts. For the election year USP's taxable income consists of \$200x of foreign source nondeductible CFC dividends subject to no foreign tax. USP's pre-credit regular tax liability is \$70x ($.35 \times \$200x$). USP has no preference items.

(ii) Result. Taking into account the adjustments required by section 965(e)(1)(B) for purposes of computing USP's alternative minimum tax under section 55 in the election year, USP's taxable income computed without regard to the \$200x of nondeductible CFC dividends is \$0, which would result in a pre-credit regular tax liability of \$0. USP's alternative minimum taxable income computed without regard to the \$200x of nondeductible CFC dividends is also \$0, so its tentative minimum tax, computed without regard to the nondeductible CFC dividends, is \$0. The excess of USP's adjusted tentative minimum tax of \$0 over its adjusted regular tax of \$0 results in alternative minimum tax of \$0. USP's pre-credit tax for the election year is \$70x ($\$70x$ of regular tax plus \$0 alternative minimum tax), equal to 35 percent of \$200x of nondeductible CFC dividends.

For purposes of computing USP's prior year minimum tax credit under section 53 for the election year, the modifications to section 55 that are required under section 965(e)(1)(B) do not apply. Accordingly, for purposes of computing the limitation of section 53(c), USP's regular tax liability is \$70x ($.35 \times \$200x$ of taxable income including nondeductible CFC dividends), its tentative minimum tax is \$40x ($.20 \times \$200x$ of alternative minimum taxable income including nondeductible CFC dividends), and the excess of the regular tax liability over the tentative minimum tax for the election year is \$30x ($\$70x - \$40x$). USP may claim a credit under section 53(a) in the election year for the excess (if any) of its adjusted net minimum tax imposed for all post-1986 taxable years prior to the election year over the amount allowable as a credit under section 53(a) for such prior taxable years, up to the \$30x limitation computed under section 53(c).

Example 4. AMT with no foreign tax credit and prior year minimum tax credit. (i)

Facts. For the election year USP's taxable income consists of \$200x of foreign source general limitation nondeductible CFC dividends subject to no foreign tax and \$400x of U.S. source income. USP's pre-credit regular tax liability is \$210x ($.35 \times \$600x$). USP has \$350x of U.S. source preference items described in section 57(a)(5).

(ii) Result. Taking into account the adjustments required by section 965(e)(1)(B) for purposes of computing USP's alternative minimum tax under section 55 in the election year, USP's taxable income computed without regard to the \$200x of nondeductible CFC dividends is \$400x, which would result in a pre-credit U.S. regular tax liability of \$140x ($.35 \times \$400x$). USP's alternative minimum taxable income computed without regard to the \$200x of nondeductible CFC dividends is \$750x, taxable income of \$400x increased by \$350x of preference items. USP's tentative minimum tax, computed without regard to the nondeductible CFC dividends, is \$150x ($.20 \times \$750x$). The excess of USP's adjusted tentative minimum tax of \$150x over its adjusted regular tax of \$140x results in alternative minimum tax of \$10x. USP's pre-credit tax for the election year is \$220x (\$210x of regular tax plus \$10x of alternative minimum tax). This amount is equivalent to \$150x (20 percent of \$750x, USP's alternative minimum taxable income exclusive of the nondeductible CFC dividends), plus \$70x (35 percent of \$200x of nondeductible CFC dividends).

For purposes of computing USP's prior year minimum tax credit under section 53 for the election year, the modifications to section 55 that are required under section 965(e)(1)(B) do not apply. Accordingly, for purposes of computing the limitation of section 53(c), USP's regular tax liability is \$210x ($.35 \times \$600x$ of regular taxable income including nondeductible CFC dividends), its tentative minimum tax is \$190x ($.20 \times \$950x$ of alternative minimum taxable income including nondeductible CFC dividends), and the excess of the regular tax liability over the tentative minimum tax for the election year is \$20x ($\$210x - \$190x$). USP may claim a credit under section 53(a) in the election year for the excess (if any) of its adjusted net minimum tax imposed for all post-1986 taxable years prior to the election year over the amount allowable as a credit under section 53(a) for such prior taxable years, up to the \$20x limitation computed under section 53(c).

Example 5. AMT with foreign tax credit and prior year minimum tax credit. (i)

Facts. The facts are the same as in Example 2, except that USP has \$200x rather than \$600x of U.S. source preference items.

(ii) Result. Taking into account the adjustments required by section 965(e)(1)(B) for purposes of computing USP's alternative minimum tax under section 55 in the election year, USP's taxable income computed without regard to the \$200x of nondeductible CFC dividends is \$400x, which would result in a pre-credit U.S. regular tax liability of \$140x ($.35 \times \$400x$). USP's pre-credit tentative minimum tax, computed without regard to the nondeductible CFC dividends, is \$120x ($.20 \times \$600x$).

USP's allowable foreign tax credit computed for regular tax purposes is \$90x, the lesser of \$100x, the foreign taxes paid, \$140x, the regular section 904 limitation ($(\$400x \text{ FSTI} / \$600x \text{ WWTI}) \times \$210x \text{ pre-credit U.S. tax}$), or \$90x, the section 965(e) limitation ($\$20x \text{ foreign tax on nondeductible CFC dividends} + \$70x, \text{ the limitation on other income of } ((\$200x \text{ FSTI} / \$400x \text{ WWTI}) \times \$140x)$). The portion of the allowable regular foreign tax credit that is attributable to the nondeductible CFC dividends is \$20x, the smaller of the \$70x pre-credit U.S. tax on the nondeductible CFC dividends ($.35 \times \$200x$) or \$20x, the foreign taxes paid or accrued with respect to the nondeductible CFC dividends. The remaining \$70x of the allowable regular foreign tax credit is the amount attributable to USP's other foreign source income. Accordingly, USP's regular tax described in section 55(c), computed without regard to the tax on nondeductible CFC dividends, is \$70x ($\$140x \text{ regular tax} - \$70x \text{ foreign tax credit}$).

Computed without regard to section 965(e)(1)(B), USP's alternative minimum tax foreign tax credit is \$60x, the lesser of \$100x, the foreign taxes paid, \$80x, the regular alternative minimum tax foreign tax credit limitation ($(\$400x \text{ FSAMTI} / \$800x \text{ WWAMTI}) \times \$160x$), or \$60x, the section 965(e) limitation ($\$20x + (\$200x \text{ FSAMTI} / \$600x \text{ WWAMTI}) \times \$120x$). The portion of the alternative minimum tax foreign tax credit that is attributable to nondeductible CFC dividends is \$20x, the lesser of \$40x, the pre-credit tentative minimum tax on the nondeductible CFC dividends ($.20 \times \$200x$) or \$20x, the foreign taxes paid or accrued with respect to the nondeductible CFC dividends. The \$40x balance of the alternative minimum tax foreign tax credit is attributable to USP's other foreign source income. Accordingly, USP's tentative minimum tax described in section 55(b)(1)(B), computed without regard to the tax on nondeductible CFC dividends, is \$80x ($\$120x - \$40x$). Under section 55 as modified by section 965(e)(1)(B), the excess of USP's tentative minimum tax over its regular tax is \$10x ($\$80x - \$70x$).

For purposes of computing USP's prior year minimum tax credit under section 53 for the election year, the modifications to section 55 that are required under section 965(e)(1)(B) do not apply. Accordingly, for purposes of computing the limitation of section 53(c), USP's pre-credit regular tax liability is \$210x ($.35 \times \$600x$ of taxable income including nondeductible CFC dividends) and its pre-credit tentative minimum tax liability is \$160x ($.20 \times \$800x$ of alternative minimum taxable income including nondeductible CFC dividends). As described above, USP's regular and AMT foreign tax credits are limited under section 965(e) to \$90x and \$60x, respectively. Therefore, for purposes of section 53(c) USP's regular tax liability is \$120x ($\$210x - \$90x \text{ foreign tax credit}$), its tentative minimum tax is \$100x ($\$160x - \$60x \text{ alternative minimum tax foreign tax credit}$), and the excess of its regular tax over its tentative minimum tax is \$20x ($\$120x - \$100x$). USP may claim a credit under section 53(a) in the election year for the excess (if any) of its adjusted net minimum tax imposed for all post-1986 taxable years prior to the election year over the amount allowable as a credit under section 53(a) for such prior taxable years, up to \$20x, the limitation computed under section 53(c).

Example 6. Minimum tax credit after OFL recapture. (i) Facts. The facts are the same as in Example 5, except that USP has a pre-2005 general limitation OFL account of \$500x.

(ii) Result. Under section 904(f)(1), unless USP elects to recapture a larger percentage of the OFL account, 50 percent or \$250x of USP's \$400x of foreign source general limitation income is recharacterized as U.S. source income. After OFL recapture USP has \$150x of foreign source general limitation income, all attributable to nondeductible CFC dividends. See section 8.03 of this notice. Pursuant to section 9.02 of this notice, \$15x ($(\$150x/\$200x) \times \$20x$) of foreign tax is paid or accrued with respect to the \$150x of nondeductible CFC dividends.

Pursuant to sections 9.03 and 9.05 of this notice, for purposes of computing USP's alternative minimum tax under section 55 in the election year, USP's pre-credit regular tax and pre-credit tentative minimum tax are computed without regard to the \$200x of nondeductible CFC dividends, as determined under section 965(e)(3) without regard to the recharacterization of \$50x of nondeductible CFC dividends as U.S. source income pursuant to the recapture of USP's general limitation OFL account under section 904(f) and section 8.03 of this notice. As in Example 5, USP's pre-credit regular tax and pre-credit tentative minimum tax, computed without regard to nondeductible CFC dividends, are \$140x and \$120x, respectively.

USP's allowable foreign tax credit computed for regular tax purposes is \$15x, the lesser of \$100x, the foreign taxes paid, \$52.50x, the regular section 904 limitation ($(\$150x \text{ FSTI}/\$600x \text{ WWTI}) \times \$210x \text{ pre-credit U.S. tax}$), or \$15x, the section 965(e) limitation (\$15x foreign tax on nondeductible CFC dividends + \$0, the limitation on other income of $(\$0 \text{ FSTI}/\$400x \text{ WWTI}) \times \$140x$). Pursuant to section 9.03 of this notice, the portion of the allowable regular foreign tax credit that is attributable to the nondeductible CFC dividends is \$15x, the smaller of the \$52.50x pre-credit U.S. tax on the reduced amount of nondeductible CFC dividends ($.35 \times \$150x$) or \$15x, the foreign taxes paid or accrued with respect to the reduced amount of nondeductible CFC dividends. Therefore, no foreign tax credit is attributable to USP's other foreign source income. Accordingly, USP's regular tax described in section 55(c), computed without regard to the tax on nondeductible CFC dividends, is \$140x (\$140x regular tax - \$0 foreign tax credit).

Computed without regard to section 965(e)(1)(B), USP's alternative minimum tax foreign tax credit is \$15x, the lesser of \$100x, the foreign taxes paid, \$30x, the regular alternative minimum tax foreign tax credit limitation ($(\$150x \text{ FSAMTI}/\$800x \text{ WWAMTI}) \times \$160x$) or \$15x, the section 965(e) limitation ($\$15x + (\$0 \text{ FSAMTI}/\$600x \text{ WWAMTI}) \times \$120x$). Pursuant to section 9.03 of this notice, the portion of the alternative minimum tax foreign tax credit that is attributable to nondeductible CFC dividends is \$15x, the lesser of \$30x, the pre-credit tentative minimum tax on the nondeductible CFC

dividends (.20 x \$150x) or \$15x, the foreign taxes paid or accrued with respect to the nondeductible CFC dividends. Accordingly, none of the alternative minimum tax foreign tax credit is attributable to USP's other foreign source income. Therefore, USP's tentative minimum tax described in section 55(b)(1)(B), computed without regard to the tax on nondeductible CFC dividends, is \$120x (\$120x tentative minimum tax - \$0 alternative minimum tax foreign tax credit). Under section 55 as modified by section 965(e)(1)(B), USP's regular tax of \$140x exceeds its tentative minimum tax of \$120x. Therefore, USP does not owe AMT for the election year.

For purposes of computing USP's prior year minimum tax credit under section 53 for the election year, the modifications to section 55 that are required under section 965(e)(1)(B) do not apply. Accordingly, for purposes of computing the limitation of section 53(c), USP's pre-credit regular tax is \$210x (.35 x \$600x of taxable income including nondeductible CFC dividends) and its pre-credit tentative minimum tax is \$160x (.20 x \$800x of alternative minimum taxable income including nondeductible CFC dividends). As described above, USP's regular and AMT foreign tax credits are limited under section 965(e) to \$15x, all attributable to nondeductible CFC dividends. Therefore, for purposes of section 53(c) USP's regular tax liability is \$195x (\$210x - \$15x foreign tax credit), its tentative minimum tax is \$145x (\$160x - \$15x alternative minimum tax foreign tax credit), and the excess of its regular tax over its tentative minimum tax is \$50x (\$195x - \$145x). USP may claim a credit under section 53(a) in the election year for the excess (if any) of its adjusted net minimum tax imposed for all post-1986 taxable years prior to the election year over the amount allowable as a credit under section 53(a) for such prior taxable years, up to \$50x, the limitation computed under section 53(c).

SECTION 10. OTHER GUIDANCE

.01 Application of General Tax Law Principles

Unless otherwise specifically provided, general tax law principles, including the circular cash flow, step-transaction, and substance-over-form doctrines, apply for purposes of determining the federal income tax consequences of transactions undertaken in connection with section 965. For example, assume USP, a domestic corporation, wholly owns CFC1 which, in turn, wholly owns CFC2. If CFC2 declares a dividend and CFC1 declares a dividend of the same amount, and, at the direction of

CFC1, CFC2 pays the amount of its dividend in cash directly to USP, then under applicable Code provisions, including section 965, such payment shall be treated as a distribution of cash from CFC2 to CFC1, followed by a distribution of cash from CFC1 to USP. See, e.g., Rev. Rul. 80-292, 1980-2 C.B. 104.

.02 Base Period Inclusions under Section 965(b)(2)(B)

In computing a taxpayer's base period amount, section 965(b)(2)(B)(i) includes dividends described in section 965(c)(3) that were received during each base period year from CFCs, section 965(b)(2)(B)(ii) includes amounts includible in gross income for each base period year under section 951(a)(1)(B) with respect to CFCs, and section 965(b)(2)(B)(iii) includes amounts that would have been included for each base period year but for section 959(a). For this purpose, dividends received from CFCs by a disregarded entity or a partnership owned by a U.S. shareholder during a base period year shall be treated as received by such U.S. shareholder to the extent the dividend was included in income shown on the U.S. shareholder's return described in section 965(b)(2) for the base period year, regardless of whether cash or property in the amount of the dividend was received by the shareholder in the base period year. In addition, for purposes of section 965(b)(2)(B), amounts includible under section 951(a)(1)(B) (or that would have been so included but for section 959(a)) in gross income of a domestic partnership that was owned by a U.S. shareholder during a base period year shall be treated as includible in the U.S. shareholder's income under section 951(a)(1)(B), or excluded under section 959(a), to the extent the includible amount was (i) allocated to the U.S. shareholder-partner under the rules of sections 702 and 704 and the

regulations thereunder in a base period year; and (ii) separately stated to the partner under Treas. Reg. §1.702-1(a)(8)(ii).

.03 Allocation of \$500 Million Limitation—Clarification of Section 4.05 of Notice 2005-38

Section 4.05 of Notice 2005-38 provides that the \$500 million limitation on qualifying dividends described in section 965(b)(1)(A) is allocated among the qualified members of a section 52(a) group in proportion to the aggregate amount of total current and accumulated non-previously-taxed earnings and profits of all CFCs owned (within the meaning of section 958(a)) by such qualified members, determined with reference to the earnings and profits appropriately reported on Schedule J of the last Form 5471 filed on or before the apportionment date. For this purpose, the amount of non-PTI earnings and profits of a CFC taken into account by a qualified member is that member's pro rata share of the CFC's earnings and profits, determined in accordance with section 951(a)(2) for the year for which Form 5471 was filed.

.04 Effect of Restatement of Certified Financial Statement

A restatement of a previously filed and certified financial statement described in section 965(c)(1) that occurs after June 30, 2003, does not alter the statement's status as having been filed and certified on or before June 30, 2003. In such a case, the limitations described in section 965(b)(1)(B) and (C) are the amount of earnings permanently reinvested outside the United States, and a specific amount of tax liability, respectively, that are shown on the statement as originally filed, not the amounts shown on the restatement.

.05 Definition of United States

For purposes of section 965, the term “United States” includes the 50 states, the District of Columbia, the territorial waters of the United States, and the seabed and subsoil of those submarine areas that are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources. The term “United States” does not include possessions and territories of the United States or the airspace over the United States and these areas.

.06 Treatment of Accounts Payable Resulting from Section 482 Adjustments

Accounts payable established under Rev. Proc. 99-32, 1999-2 C.B. 296, in connection with section 482 adjustments are treated as indebtedness for purposes of section 965(b)(3).

.07 Exceptions to Related Party Indebtedness for Certain Ordinary Course

Transactions of Banks and Dealers in Securities—Addition to Section 7.02 of Notice 2005-38

For purposes of section 965(b)(3), the term “indebtedness” does not include indebtedness of a CFC arising in the ordinary course of business as a bank or as a dealer in securities that would not be treated as U.S. property under section 956(c)(2)(A)(i), (J), (K), or (L) were it an obligation of a United States person (and not of the CFC). For purposes of applying the exception under section 956(c)(2)(A)(i), a “bank” is a CFC that meets the definition of a bank in section 585(a)(2)(B), without regard to the second sentence thereof, and without regard to whether the CFC is engaged in a U.S. trade or business, provided that the CFC operates under the laws of

the foreign jurisdiction where it is engaged in business and is subject to supervision and examination by an authority having supervision over banking institutions in that jurisdiction (in lieu of supervision by a Federal or State supervisory authority).

.08 Intercompany Trade Payables--Modification of Section 7.02 of Notice 2005-38

For purposes of section 965(b)(3), in addition to the exceptions described in section 7.02 of Notice 2005-38 and section 10.07 of this notice, the term “indebtedness” does not include indebtedness of a CFC arising in the ordinary course of a business from licenses, provided that such indebtedness is actually paid within 183 days.

.09 Distributions to Intermediary Partnerships—Clarification of Section 3.02 of Notice 2005-10 and Section 9.06 of Notice 2005-38

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 a cash distribution in the amount of the CFC dividend during the election year. Section 9.06 of Notice 2005-38 provides a limited exception to the general cash distribution requirement with respect to cash dividends paid to a disregarded entity. This limited exception does not apply to cash dividends paid to a partnership. Therefore, a cash dividend paid by a CFC to a partnership that is owned by a U.S. shareholder is treated as received by such U.S. shareholder only if and to the extent the partnership distributes cash to the shareholder-partner in the election year. For this purpose, a distribution of cash does not include a guaranteed payment, as defined in section 707(c), or a payment made to the shareholder other than in its

capacity as a member of the partnership.

.10 Domestic Reinvestment Plans—Clarification of Section 4.01 of Notice 2005-10

Section 965(b)(4)(B) provides that section 965(a) shall not apply to any dividend received by a U.S. shareholder unless the amount of the dividend is invested in the United States pursuant to a domestic reinvestment plan which provides for the reinvestment of such dividend in the United States. Section 4.01 of Notice 2005-10 provides that a taxpayer may adopt separate domestic reinvestment plans to apply to different cash dividends made during the election year. A taxpayer may, but is not required to, adopt a domestic reinvestment plan that provides for the reinvestment of cash dividends only from specified CFCs, to the extent of the dollar amounts of anticipated investments that are specified in the plan in accordance with section 4.03 of Notice 2005-10. In this situation, cash dividends from other CFCs in the election year that are not covered by another domestic reinvestment plan will not be subject to the section 965(a) DRD or to the disallowance of deductions and credits under section 965(d), even if the dollar amount of cash dividends from the specified CFCs is less than the total dollar amount of anticipated investments specified in the plan and if the taxpayer in fact expends the total dollar amount specified in the plan on permitted investments. On the other hand, a taxpayer may not choose to claim the section 965(a) DRD with respect to less than all of the qualifying dividends that are covered by a domestic reinvestment plan, assuming that all such amounts are properly reinvested in accordance with the plan and that all the other requirements under section 965 are satisfied. For example, assume that USP wholly owns CFC1 and CFC2. USP properly

adopts a domestic reinvestment plan that provides for the reinvestment of up to \$10 million of qualifying dividends in the United States. During the election year CFC1 pays qualifying dividends of \$8 million, CFC2 pays qualifying dividends of \$2 million, USP invests at least \$10 million in permitted investments, and all the other requirements of section 965 are met. Unless the plan provides only for the reinvestment of qualifying dividends from either CFC1 or CFC2, the entire \$10 million of qualifying dividends is subject to section 965.

.11 Qualified Plan Funding--Clarification of Section 5.05(b) of Notice 2005-10

Section 5.05(b) of Notice 2005-10 provides, in part, that the satisfaction of an obligation to fund a qualified plan ordinarily will contribute to the financial stabilization of the taxpayer. For this purpose, contributions to a qualified pension plan that do not give rise to excise tax under section 4972 (which imposes a tax on certain nondeductible pension contributions) will be considered to satisfy an obligation to fund a qualified plan even if those contributions are not currently deductible. Contributions to a qualified profit sharing or stock bonus plan also qualify for this purpose if those contributions to the plan are required under a fixed contribution formula provided under the terms of the plan. Contributions to a qualified profit sharing or stock bonus plan do not qualify if contributions to the plan are made on a discretionary basis.

SECTION 11. TRANSITION RULES

.01 Domestic Reinvestment Plans Approved Prior to August 19, 2005

If a domestic reinvestment plan is approved prior to August 19, 2005, the

taxpayer may modify such plan to take into account the guidance herein not later than October 19, 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 August 19, 2005

If, prior to August 19, 2005, a taxpayer has filed its tax return for the taxable year to which it elects section 965 to apply, such taxpayer may revise its computations or annual reporting to conform to the guidance in this notice on an amended tax return that is filed by December 31, 2005.

SECTION 12. EFFECT ON OTHER DOCUMENTS

Sections 10.09, 10.10, and 10.11 of this notice clarify sections 3.02, 4.01, and 5.05(b), respectively, of Notice 2005-10. Section 10.03 of this notice modifies section 4.05, section 10.09 clarifies section 9.06, and section 10.07 makes an addition to and section 10.08 modifies section 7.02, of Notice 2005-38. See also section 11 of this notice, pursuant to which domestic reinvestment plans approved prior to August 18, 2005, (including domestic reinvestment plans adopted or modified pursuant to the guidance included in Notice 2005-10 and Notice 2005-38), may be modified to take into account the guidance in this notice.

SECTION 13. EFFECTIVE DATE

This notice is effective for taxable years ending on or after October 22, 2004.

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 1545-1957.

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 3 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 calculated its taxable income and allowable credits with respect to qualifying dividends, taking into account the limitations imposed by sections 965(d) and (e). 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: 250,000 hours.

Estimated average annual burden hours per respondent: 10 hours.

Estimated number of respondents: 25,000.

Estimated annual frequency of responses: once.

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 October 19, 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 author of this notice is Barbara Allen Felker of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in its development. For further information regarding this notice contact Ms. Felker or Michael Gilman at (202) 622-3850 (not a toll-free call).