

**Actions Are Needed to Ensure Corporations
Receive Intended Tax Benefits for Reinvesting
Foreign Earnings in the United States**

September 2005

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 23, 2005

MEMORANDUM FOR COMMISSIONER, LARGE AND MID-SIZE BUSINESS
DIVISION

Pamela J. Gardiner

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Actions Are Needed to Ensure Corporations
Receive Intended Tax Benefits for Reinvesting Foreign Earnings
in the United States (Audit # 200530008)

This report presents the results of our review of the Internal Revenue Service's (IRS) implementation of Provision 422 of the American Jobs Creation Act of 2004 (AJCA).¹ The overall objective of this review was to determine whether the IRS effectively completed the planned actions to implement this Provision of the AJCA regarding the incentives to reinvest foreign earnings in the United States (U.S.).

In summary, actions are needed to ensure corporations receive intended tax benefits for reinvesting foreign earnings in the U.S. The IRS developed and provided priority guidance and established controls related to the implementation of Provision 422. The IRS provided much of the required guidance on issues identified by external and internal stakeholders in multiple notices, fact sheets, and a draft of the required Form 8895² from January through May 2005. The date of enactment of the AJCA gave the IRS limited time to issue complete guidance to taxpayers.

Although the IRS developed and provided priority guidance, it did not issue all of the necessary guidance in sufficient time for some taxpayers to determine their dividends received deduction and elect the most beneficial taxable year. Also, the required tax form to compute the dividends received deduction was not timely provided to taxpayers, even though the IRS' initial guidance directed taxpayers to use the form.

¹ Pub. L. No. 108-357, 118 Stat. 1418 (2004).

² One-Time Dividends Received Deduction for Certain Cash Dividends from Controlled Foreign Corporations (Form 8895) was issued in preliminary draft form, without instruction, and posted to the IRS Draft Forms web site on May 12, 2005.

Two factors hindered the issuance of timely and complete guidance: (1) the complexity of the law combined with the short implementation period and (2) certain issues needing technical corrections that were pending enactment by Congress.

Because guidance was not always complete or timely, some taxpayers were at a greater risk of being unable to determine the correct dividends received deduction and to choose between 2 taxable years as the most beneficial taxable year in which to bring the foreign earnings into the U.S. Certain unresolved issues may have prevented many companies from completing their dividend distribution plans or claiming millions of dollars in dividends received deductions. Without the required tax form and related instructions, there was a greater risk of taxpayers incorrectly computing their allowable dividends received deductions. Taxpayers could either understate or overstate their deductions and be subjected to a substantial tax (up to 35 percent) on dividends received deductions that would have otherwise been taxed at a rate of 5.25 percent. In addition, there is a greater probability that amended returns would be necessary because taxpayers did not have complete instructions and the required Form 8895 was not available.

We recommended the Commissioner, Large and Mid-Size Business (LMSB) Division, evaluate the impact of insufficient guidance on hindering taxpayers from taking the deduction in the earlier of the 2 taxable years or both taxable years and coordinate with the Office of Chief Counsel to elevate this matter to the Department of the Treasury. A determination needs to be made as to whether legislation is necessary to extend the time needed to ensure corporate taxpayers have complete guidance to enable them to appropriately plan and receive the intended tax benefits for reinvesting foreign earnings in the U.S. Also, we recommended the Commissioner, LMSB Division, coordinate with responsible officials to ensure the required Form 8895 and related instructions are issued as soon as possible and provide guidance regarding the filing of amended returns to assist taxpayers in complying with Provision 422, when the deductions have already been improperly taken or computed.

Management's Response: The Commissioner, LMSB Division, disagreed with our evaluation regarding the timeliness of the relevant guidance, form, and instructions. The IRS believes its extraordinary efforts to expedite guidance, and issue the relevant form and instructions, met the challenge of facilitating compliance under a complex statute in an exceedingly short time. The IRS indicated that extending the Internal Revenue Code Section 965 election³ for an additional year would have significant revenue implications that undoubtedly were already part of Congress' consideration in enacting Provision 422. Also, the IRS indicated the final Form 8895 and its related instructions were forwarded to IRS multimedia on August 18, 2005, for release to the public. In addition, the IRS indicated that complete guidance and instructions have already been provided to taxpayers in three priority notices and the instructions for Form 8895, with regard to filing amended returns or other information for purposes of

³ AJCA Provision 422 resulted in adding Section 965, Temporary Dividends Received Deduction, to the Internal Revenue Code.

complying with Internal Revenue Code Section 965. Management's complete response to the draft report is included as Appendix IV.

Office of Audit Comment: Congressional intent for Provision 422 was to allow taxpayers to choose between 2 years (either Tax Years 2004 or 2005) to bring foreign earnings back into the U.S. Since it took the IRS up to 10 months to issue needed guidance after enactment of the legislation, certain Calendar Year 2004 filers and fiscal year filers through August 19, 2005, did not have all the guidance necessary to choose the most beneficial tax year. Our report has recognized factors outside the IRS' control that contributed to this delay.

However, in the interest of ensuring corporate taxpayers receive tax benefits as intended, there are several reasons why the IRS should evaluate the impact of the insufficient guidance provided during the initial 10 months after enactment of Provision 422 on October 22, 2004. From news releases and other online services, it was clear that taxpayers were affected as a result of waiting for the IRS' position before developing their reinvestment plans. It was recognized that the lack of timely guidance and many unanswered questions caused some taxpayers to choose the later of the 2 allowable years. The issuance of 3 separate notices in January, May, and August 2005, in excess of 150 pages and containing interrelated instructions, had to affect the taxpayers' ability to choose the election and accurately calculate the amount of foreign earnings to be brought into the U.S. and the allowable dividends received deductions. Instructions issued in three intervals could have caused additional confusion and multiple amended returns.

In addition, to assist taxpayers in complying with Provision 422, the instructions regarding filing amended returns should have been more extensive and care should have been given to instructing taxpayers on filing amended returns once complete guidance was provided. In January and May 2005, guidance was provided to taxpayers indicating they could file amended returns. However, needed guidance concerning computation of the dividends received deduction and the related form needed for the computation were not issued until August 2005. As a result, there was a greater risk of errors in computations and application of the law. In three separate notices, taxpayers were advised that they could file amended returns with regard to specific limited situations, potentially causing multiple amended returns to be filed.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Curtis Hagan, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

**Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits
for Reinvesting Foreign Earnings in the United States**

Table of Contents

Background	Page 1
The Internal Revenue Service Provided Priority Guidance and Established Controls Related to Implementation of Provision 422	Page 2
Some Taxpayers Were Not Timely Provided With All of the Guidance Necessary to Determine Their Dividends Received Deduction and to Elect the Most Beneficial Taxable Year	Page 4
<u>Recommendation 1:</u>	Page 10
Taxpayers Were Not Timely Provided With the Required Tax Form to Compute Their Dividends Received Deduction	Page 12
<u>Recommendations 2 and 3:</u>	Page 14
Appendix I – Detailed Objective, Scope, and Methodology	Page 16
Appendix II – Major Contributors to This Report	Page 18
Appendix III – Report Distribution List	Page 19
Appendix IV – Management’s Response to the Draft Report	Page 20

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

Background

On October 22, 2004, President Bush signed the American Jobs Creation Act of 2004 (AJCA).¹ Among the provisions of this Act, Provision 422, Incentives to Reinvest Foreign Earnings in the United States (U.S.), provides that certain dividends received by a U.S. corporation from controlled foreign corporations are eligible for an 85 percent dividends received deduction. It was intended that this deduction and the related reduction in U.S. taxes afforded these taxpayers will stimulate the U.S. domestic economy by triggering the reinvestment of foreign earnings into the U.S. that otherwise would have remained abroad.²

At the taxpayer's election, this deduction is available for dividends received during either the taxpayer's first taxable year beginning on or after the date of enactment of the Act (October 22, 2004) or the taxpayer's last taxable year beginning before such date. Dividends received after the election period will be taxed in the normal manner under present law. The deduction applies only to cash dividends.

Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such distribution, the U.S. tax on the income generally is deferred.

The Large and Mid-Size Business (LMSB) Division was the operating division assigned the primary responsibility for implementation of Provision 422. The LMSB Division's actions to implement Provision 422 involved multiple action items, including providing training and guidance to Internal Revenue Service (IRS) employees and taxpayers, coordinating extensively with various IRS components, creating and revising forms and publications, and generally taking the necessary actions to effectively implement this Provision.

This audit was conducted during the period February through June 2005 at the IRS office in Holtsville, New York, covering the LMSB Division's

¹ Pub. L. No. 108-357, 118 Stat. 1418 (2004).

² The source of this information is from American Jobs Creation Act of 2004, Laws, Explanation and Analysis, page 217, CCH Incorporated.

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

The Internal Revenue Service Provided Priority Guidance and Established Controls Related to Implementation of Provision 422

responsibility in implementing Provision 422. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

The timing of enactment of the legislation involving Provision 422 gave the IRS limited time to issue complete guidance to taxpayers that would benefit from taking the dividends received deduction.

We were advised that, after enactment of Provision 422, the IRS designated guidance for this Provision as a top-priority item and made a significant staffing commitment, including having officials at the highest levels begin a coordinated outreach to both external and internal stakeholders in meetings, conferences, correspondence, and telephone calls for purposes of identifying and prioritizing issues needing guidance under the new Provision.

The IRS focused on addressing those priority issue areas and addressing them in the priority order that had been established in the course of its outreach to external and internal stakeholders. Thus, the IRS targeted the issuance of three priority notices: the first primarily addressing domestic reinvestment plans and investments in the U.S., the second primarily addressing the effects of mergers and acquisitions, and the third primarily addressing computational issues.

On January 13, 2005, approximately 3 months after enactment of Provision 422, the IRS issued Notice 2005-10 as well as a Fact Sheet. It addressed multiple issues, including adoption, content and compliance for domestic reinvestment plans, the kinds of investments in the U.S. for which the distributed dividends may be used under this program, definitions of terms, and a description of how taxpayers can elect to apply this section to the taxable year. This Notice was made available to major national and tax media and was included on the IRS web site (IRS.gov).

On May 10, 2005, the IRS issued detailed guidance in Notice 2005-38, for the second in a series of notices to provide much-anticipated direction on the effects of mergers, acquisitions, and reorganizations in calculating the

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

amount of eligible dividends. It included detailed explanations of new rules on qualifying dividends, maximum repatriations,³ and related-party indebtedness.

On May 12, 2005, the IRS posted to the Draft Forms web site a draft of One-Time Dividends Received Deduction for Certain Cash Dividends from Controlled Foreign Corporations (Form 8895).⁴ We were informed that, in accordance with standard procedure, the timing of this issuance was coordinated with the guidance in process so the draft Form 8895 was as close as possible to what is anticipated to be the final version of the Form. The IRS believed this should enable interested parties to have confidence that the product would be substantially similar to the final version that is anticipated to be released in August 2005.

In August 2005, the third priority notice was anticipated to be issued⁵ to address important computational issues relating to the foreign tax credit, allocation of deductions, currency translation, and the alternative minimum tax.

As part of the IRS' outreach effort, the LMSB Division, through the Office of Prefiling and Technical Guidance, established a joint IRS/stakeholder working group to handle issues related to the implementation of Provision 422 and Internal Revenue Code (I.R.C.) Section (§) 965.⁶ In addition to LMSB Division employees, the group is comprised of members of the American Bar Association, the American Institute of Certified Public Accountants, the Manufacturers Alliance Product Innovation, and the Treasury Executives Institute. The Office of Associate Chief Counsel (International) addressed the new I.R.C. § 965 through an International Network News release

³ The American Jobs Creation Act of 2004 – Conference Report by CCH Incorporated refers to repatriation as follows: “Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation.”

⁴ The IRS posted the preliminary draft Form 8895, without the related instructions, to the Draft Forms web site on May 12, 2005.

⁵ The IRS issued the third priority notice, Notice 2005-64 on August 19, 2005.

⁶ AJCA Provision 422 resulted in adding § 965, Temporary Dividends Received Deduction, to the I.R.C.

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

on January 21, 2005, which was sent to international personnel within both the Office of Chief Counsel and the LMSB Division.

The LMSB Division created for its employees an AJCA web page for its web site that contained links to the notices, news releases, fact sheets, and other existing technical guidance relating to the AJCA.

In addition, the IRS has the Legislative Implementation Tracking System (LITS), which is an IRS Intranet-based planning and monitoring system for implementation of tax legislation. It is designed to enable the responsible offices to monitor legislation that has a significant impact on the IRS. The web site has the required actions with estimated due dates and indicates the functions responsible for taking the necessary actions to implement the provisions. Also, the web site shows which action items are on time or running behind schedule.

Some Taxpayers Were Not Timely Provided With All of the Guidance Necessary to Determine Their Dividends Received Deduction and to Elect the Most Beneficial Taxable Year

Although the IRS developed and provided priority guidance and established controls related to implementation of Provision 422, some taxpayers were not provided with sufficient guidance.

Provision 422 was enacted on October 22, 2004, which gave the IRS a very short window of opportunity for ensuring all aspects needed to successfully implement this Provision of the law were completed. Initial guidance was issued in January 2005, followed by more detailed guidance and the draft Form 8895 in May 2005, with the need for still additional guidance. In August 2005, a third notice was anticipated to be issued to address remaining priority issues, and the final Form 8895 and instructions were scheduled to be released.

This new Provision is a “1-year only” opportunity. At the taxpayer’s election, the deduction is available for dividends received during the taxpayer’s first tax year that begins during the 1-year period beginning on October 22, 2004, or during the taxpayer’s last tax year beginning before October 22, 2004. Therefore, these 2 options generally allow taxpayers to take this deduction in 1 of 2 taxable years.

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

A Calendar Year taxpayer would have had fewer than 3 months in 2004 (October 22 to December 31, 2004) to take the dividends received deduction, without having any guidance. For approximately one-half of Calendar Year 2005, complete guidance had not been provided to taxpayers.⁷ We determined approximately 67 percent of corporate filers are calendar year filers and 33 percent are fiscal year filers.

Also, the filing of an extension to file after the due date of the return will give the taxpayer more time to file a tax return. However, it would not increase or change the time required to bring the cash dividends into the U.S. or allow more time to review and consider any additional or newly issued guidance, to determine the amount of dividends to bring in or claim as a deduction. Taxpayers would also have to anticipate the amount of tax due and make the necessary payment at the time the extension is filed.

IRS and Department of the Treasury officials commented publicly, in news articles and in Notices 2005-10 and 2005-38, that additional notice(s) are expected to provide guidance regarding the implementation of Provision 422.

Issues identified in the Fact Sheet and related Notice 2005-38 by the IRS as still needing additional notice(s) included:

- The impact of Provision 422 on a corporation's computation of its tax liability.
- The use of foreign tax credits and the deduction of certain expenses to offset the nondeductible portion of the dividends received deduction.

Management indicated these issues will be addressed in the third priority notice anticipated to be issued in August 2005.

The following factors have hindered the issuance of timely guidance regarding Provision 422:

⁷ Complete guidance was not issued within the first 7 months (November 2004 through May 2005) of the enactment of Provision 422. Calendar year taxpayers for 2004 and fiscal year taxpayers with tax years ending in October 2004, November 2004, or January 2005 through whenever complete guidance becomes available are at risk of incorrectly deducting dividends.

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

- The complexity of the law combined with the short implementation period made it difficult to timely issue complete guidance.
- Certain issues needing technical corrections are still pending enactment by Congress.

The complexity of the law combined with the short implementation period made it difficult to timely issue complete guidance

Provision 422 is so complex that approximately 100 pages of clarification have already been issued by the IRS, and it is still not adequate. The Department of the Treasury and IRS indicated they still need to issue additional notice(s) to answer all of the unresolved issues.

The last guidance, Notice 2005-38 (Section 965 – Limitations on dividends received deduction and other guidance) issued May 10, 2005, was over 50 pages and contained 15 sections, which demonstrates the complexity of Provision 422. The issues covered by Notice 2005-38 included:

- General principles that apply in determining the amount of cash dividends received by a U.S. shareholder that is considered extraordinary for purposes of I.R.C. § 965(b)(2).⁸
- General principles that apply in determining the maximum amount of dividends eligible under I.R.C. § 965(b)(1)⁹ to be taken into account under I.R.C. § 965(a).¹⁰
- The taxable year to which I.R.C. § 965 applies.
- The effects of certain transactions on the determination of a U.S. shareholder's limitations.

⁸ This I.R.C. Section relates to the limitations on the dividends that are considered extraordinary.

⁹ This I.R.C. Section sets forth the limitations on the amount of dividends that can be taken as a deduction.

¹⁰ This I.R.C. Section generally describes the nature of the dividends received deduction.

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

- Guidance and principles for determining under I.R.C. § 965(b)(3)¹¹ the amount of related-party indebtedness that reduces the amounts taken into account under I.R.C. § 965(a), including special adjustments made as a result of certain transactions.
- Guidance regarding the impact of certain transactions on domestic reinvestment plans.
- Other issues arising under I.R.C. § 965, including the application of I.R.C. § 78,¹² the expenses disallowed under I.R.C. § 965(d)(2),¹³ and the computation of the alternative minimum tax.
- Transition rules that apply to certain taxpayers that, prior to the issuance of this Notice, either adopted a domestic reinvestment plan or filed a tax return for a taxable year to which I.R.C. § 965 applies.

Notice 2005-38 also contained over 40 case examples (with individual sets of facts, results, and alternative facts) to aid in understanding the guidance being provided.

Certain issues needing technical corrections are still pending enactment by Congress

The IRS and Congress have recognized the need for technical corrections and, on November 19, 2004, the Tax Technical Correction Act of 2004 was introduced to correct and clarify previous tax laws.¹⁴ The bill includes technical corrections to provisions in the AJCA.

On March 17, 2005, a letter was sent to the Acting Deputy Assistant Secretary (Tax Policy) by the Chairman, Committee on Finance; the Chairman, Committee on Ways

¹¹ This I.R.C. Section relates to the reduction in benefits if there is an increase in related-party indebtedness.

¹² This I.R.C. Section is entitled Dividends Received from Certain Foreign Corporations by Domestic Corporations Choosing Foreign Tax Credit.

¹³ This I.R.C. Section generally relates to the denial of certain expenses that are allocated and apportioned to the deductible portions of dividends.

¹⁴ On November 19, 2004, the Chairman of the Committee on Ways and Means introduced H.R. 5395, Tax Technical Corrections Act of 2004. H.R. 5395 includes provisions that technically correct and clarify the intent of previous tax laws.

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

and Means; and the Ranking Member, Committee on Finance. The letter specifically indicated:

We are particularly aware that certain technical corrections may be necessary to carry out the intent of [S]ection 965 of the Internal Revenue Code, which provides a temporary dividends received deduction for a portion of the dividends received by a U.S. corporation from a controlled foreign corporation. These technical corrections would, among other things:

- 1. Clarify that the disallowance of expenses in [S]ection 965(d)(2) applies only to expenses that are “directly allocable” to the deductible portion described in [S]ection 965(d)(1)¹⁵ and*
- 2. Clarify that [S]ection 78 does not apply to any tax which is not allowable as a credit under [S]ection 901¹⁶ by reason of [S]ection 965(d).*

We anticipate introducing a technical corrections bill at the earliest opportunity in the 109th Congress, and we anticipate that the above two technical corrections will be introduced in that bill. We trust that this letter provides sufficient clarification so that appropriate guidance may be issued reflecting our intention.

While the technical corrections bill was still pending and is not limited to the two technical corrections mentioned above, IRS Notice 2005-38 did contain some guidance on these two issues.

Taxpayers may be adversely affected

Because guidance was not complete or timely, some taxpayers were at a greater risk of being unable to determine the correct dividends received deduction and choose between 2 allowable taxable years as the most beneficial taxable year in which to bring the foreign earnings into the U.S. in order to take the deduction. Also, many unresolved issues may have prevented companies from completing their

¹⁵ This I.R.C. Section generally relates to the denial of certain foreign tax credits.

¹⁶ Taxes of Foreign Countries and of Possessions of the United States.

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

dividend distribution plans until it is clearer how the unresolved issues affect them. For example:

- **Some taxpayers will be unable to plan for or take advantage of the dividends received deduction in Tax Year 2004 because complete guidance was not issued.**

An article prepared by one of the leading accounting firms in New York¹⁷ indicated:

Given the complexities and the nature of the analysis that has to be done to optimize the benefits, as well as the many unanswered questions that awaited IRS guidance—a great many of which still remain—it appears that virtually all potential beneficiaries will choose to apply the temporary Section 965 DRD¹⁸ in 2005.

This article further indicated:

In addressing the requirements of a domestic investment plan and providing much needed details as to what investments are permitted uses, Notice 2005-10 might provide some companies with enough information to allow them to develop a strategy for implementing Section 965. On the other hand, companies that expect to have significant base period issues, that have undertaken mergers, acquisitions, or divestitures during the past several years or that need to understand the direction that [the Department of the] Treasury will take in implementing the related party anti-abuse provision to be set forth in the coming technical corrections bill—to name just a few—will no doubt prefer to await additional guidance from the IRS before moving forward on Section 965 planning.

The IRS indicated that, subsequent to this article, Notice 2005-38, issued in May 2005, addressed these issues, and the remaining priority issues will

¹⁷ This article was prepared by James J. Tobin, Esq. (Ernst & Young LLP, New York, New York) and was entitled “An Analysis of the Low-Tax Repatriation Provision Enacted by the American Jobs Creation Act of 2004 and of Notice 2005-10.” The article was not dated.

¹⁸ DRD is the dividends received deduction.

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

be addressed in the third notice anticipated in August 2005.

- **Some taxpayers may be unable to claim the deduction because they could not choose the preferred taxable year (2004 or 2005) due to guidance not being available.**

One large data processing company reported to the Securities and Exchange Commission in a quarterly report ending December 31, 2004,¹⁹ that “The Company has started an evaluation of the effects of the repatriation [P]rovision; however, the Company does not expect to be able to complete this evaluation until Congress acts on the pending Technical Corrections Bill and Treasury Department [sic] provides additional clarifying language on key elements of the [P]rovision.” The company further indicated it could repatriate between \$0 and \$500 million, with the related potential range in income tax between \$0 and \$35 million.

Recommendation

The Commissioner, LMSB Division, should:

1. Evaluate the impact of insufficient guidance on hindering taxpayers from taking the deduction in the earlier of the 2 taxable years or both taxable years and coordinate with the Office of Chief Counsel to elevate this matter to the Department of the Treasury. A determination needs to be made as to whether legislation is necessary to extend the time needed to ensure corporate taxpayers have complete guidance to enable them to appropriately plan and receive the intended tax benefits for reinvesting their foreign earnings in the U.S.

Management’s Response: Management disagreed with our recommendation, indicating it was based on the assumption

¹⁹ The source of this statement is the United States Securities and Exchange Commission Form 10-Q, Quarterly Report Pursuant to Section 13 or 15(d) of The Securities Exchange Act of 1934, For the Quarterly Period Ended December 31, 2004, regarding Automatic Data Processing, Inc, Note 15, Income Taxes (Page 16 of 46) secured from the Internet.

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

that taxpayers have not been provided timely and sufficient guidance. The IRS explained in its response that relevant guidance, form, and instructions were provided timely and on a priority basis. Moreover, extending the I.R.C. § 965 election for an additional year would have significant revenue implications that undoubtedly were already part of Congress' consideration in enacting Provision 422.

Office of Audit Comment: Although management had provided guidance to help taxpayers take advantage of the dividends received deduction, the fact remains that, from October 22, 2004, through August 19, 2005 (10 months), the IRS did not provide all taxpayers with complete or timely guidance. There are multiple reasons why the IRS should evaluate the impact of the insufficient guidance provided during the initial 10 months after the enactment of Provision 422. From news releases and other online services, it was clear that taxpayers were affected because they were waiting for the IRS' position before developing their reinvestment plans. It was recognized that the lack of timely guidance and many unanswered questions caused some taxpayers to choose the later of the 2 allowable years. The issuance of 3 separate notices in January, May, and August 2005, in excess of 150 pages and containing interrelated instructions, had to affect the taxpayers' ability to choose the election and accurately calculate the amount of foreign earnings to be brought into the U.S. and the allowable dividends received deductions. Instructions issued in three intervals could have caused additional confusion and multiple amended returns. Errors in calculations could cost taxpayers millions of dollars.

Also, the Congressional intent for Provision 422 was to allow taxpayers to choose between 2 years (either Tax Years 2004 or 2005) to bring foreign earnings back into the U.S. Since it took the IRS up to 10 months to issue needed guidance, certain Calendar Year 2004 filers and fiscal year filers through August 19, 2005, did not have all the guidance necessary to choose the most beneficial tax year. Our report has recognized factors outside the IRS' control that contributed to this delay.

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

Taxpayers Were Not Timely Provided With the Required Tax Form to Compute Their Dividends Received Deduction

Four different business tax returns²⁰ directed taxpayers to use Form 8895²¹ for Tax Year 2004 to elect to take the dividends received deduction. A draft Form 8895, without the related instructions, was posted on the IRS Draft Forms web site on May 12, 2005. A statement was posted with the draft Form that cautioned taxpayers that the Form was subject to change and approval before being released. Also, it requested comments concerning the Form for the IRS' consideration, to be sent within 30 days of the posting of the Form. Management anticipated that the final Form 8895 and instructions would be available in August 2005.²²

Notice 2005-10²³ states that, if a taxpayer files its tax return for the taxable year in which it intends to elect I.R.C. § 965, but the prescribed Form 8895 has not been issued or published by the IRS, the election must be made on a statement that is attached to its timely filed tax return (including extensions) for such taxable year. However, this guidance did not provide the specific information that should be included on the statement that is to be attached to the return. The Form 8895 or statement was supposed to support the line item relating to "Dividends from foreign controlled corporations subject to the 85% deduction (Attach Form 8895)."

The action item on the LITS relating to coordinating the implementation of Provision 422 with the Tax Forms and Publications Division was shown as being completed as of December 31, 2004, while Form 8895 and related instructions have not been issued to the public.

²⁰ U.S. Corporation Income Tax Return (Form 1120), U.S. Life Insurance Company Income Tax Return (Form 1120-L), U.S. Property and Casualty Insurance Company Income Tax Return (Form 1120-PC), and Farmers' Cooperative Association Income Tax Return (Form 990-C).

²¹ One-Time Dividends Received Deduction for Certain Cash Dividends from Controlled Foreign Corporations (draft Form 8895).

²² On May 12, 2005, draft Form 8895 was posted on the IRS web site without the related instructions. The draft Form 8895 is an advance proof copy of an IRS tax form that is subject to change and Office of Management and Budget approval. The draft Form 8895 allows 30 days from the date the draft was posted on the IRS web site for comments and suggestions.

²³ Section 7, Election to Apply Section 965 to a Taxable Year.

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

A factor contributing to the inability of the IRS to provide the Form 8895 to the public is that complete guidance was not issued timely with regard to the issues related to computing the dividends received deduction. We were informed that the dates for the issuance of the final Form 8895 and instructions were pushed back to a time that coincides with the issuance of guidance contained in the next priority notice.

The draft Form 8895 developed by the IRS included information that could assist filers in computing their dividends received deduction. Parts of the Form provided a guide to taxpayers through the steps needed to:

- Determine the amount of their gross cash dividends that qualify for the deduction.
- Compute the proper amount of dividends to report on their corporate returns and help them determine their nondeductible dividends.
- Determine their regular tax liability for each of the business credits they may be entitled to claim.
- Compute an additional limitation that must be considered for separate foreign tax categories with nondeductible dividends.
- Compute their average base period repatriation level.

The draft Form 8895 also asked taxpayers to include information as to how they qualify for the deduction, to list all of the gross cash dividends they received from all controlled foreign corporations during the tax year, and to specifically identify the dividends that qualify for the deduction and those that are I.R.C. § 965(a)(2) amounts.

Since this draft Form was not scheduled to be finalized and published with instructions for taxpayers' use until August 2005, calendar year taxpayers for 2004 and fiscal year taxpayers through August 2005 that decided to claim the deduction did so without the guidance, information, and instructions for the Form 8895.

Without the Form 8895 and related instructions to facilitate computation of the basis for the allowable dividends received deduction, there is a greater risk of computing the

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

allowable dividends received deduction incorrectly (i.e., taxpayers could either understate or overstate their deductions and be subjected to a substantial tax (up to 35 percent) on dividends received deductions that, in most cases, could exceed millions of dollars and would have otherwise been taxed at a rate of 5.25 percent).²⁴ In addition, there is a greater probability that amended returns would be necessary because of errors caused by the absence of the Form 8895.

Recommendations

The Commissioner, LMSB Division, should coordinate with responsible officials to ensure:

2. Form 8895 and related instructions are issued as soon as possible.

Management's Response: The final Form 8895 and its related instructions were forwarded to IRS multimedia on August 18, 2005, for release to the public.

3. Guidance and instructions are provided with regard to filing amended returns to assist taxpayers in complying with Provision 422, when dividends received deductions have already been improperly taken or computed.

Management's Response: Complete guidance and instructions have already been provided to taxpayers in three priority Notices and the instructions for Form 8895 with regard to filing amended returns or other information for purposes of complying with I.R.C. § 965.

Office of Audit Comment: To assist taxpayers in complying with Provision 422, the instructions regarding filing amended returns should have been more extensive and care should have been given to instructing taxpayers on filing amended returns once complete guidance was provided. In January and May 2005, guidance was provided to taxpayers indicating they could file amended returns.

²⁴ The Department of the Treasury initially estimated income to the Federal Government for Provision 422 for Fiscal Year 2005 will be \$2.8 billion; however, the net effect over the 10-year period 2005-2014 would be a cost to the Federal Government of \$3.3 billion.

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

However, needed guidance concerning computation of the dividends received deduction and the related form needed for the computation were not issued until August 2005. As a result, there was a greater risk of errors in computations and application of the law. In three separate notices, taxpayers were advised that they could file amended returns with regard to specific limited situations, potentially causing multiple amended returns to be filed.

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the Internal Revenue Service (IRS) effectively completed the planned actions to implement the provision of the American Jobs Creation Act of 2004 (AJCA)¹ regarding the incentives to reinvest foreign earnings in the United States (U.S.). To accomplish this objective, we:

- I. Evaluated whether the IRS had identified and scheduled the actions necessary to implement Provision 422.
 - A. Reviewed tax legislation created by the AJCA regarding incentives to reinvest foreign earnings in the U.S.
 - B. Reviewed statistics regarding the volume of tax returns filed by business taxpayers who may be affected by AJCA Provision 422 and the volume of U.S. corporations with controlled foreign corporations.
 - C. Determined what actions have been taken by the IRS to implement AJCA Provision 422.
 1. Reviewed and monitored the Legislative Implementation Tracking System (LITS)² to identify planned actions to implement this Provision, due dates and related statuses of completion, owners and co-owners of the actions, and indications of whether the statuses were updated.
 2. Contacted the Large and Mid-Size Business (LMSB) Division to identify the steps planned and taken to identify actions still needed from each function to fully implement this Provision.
 3. Identified potential indications of the IRS' inability to meet completion dates and obtained information with regard to any completion dates that may appear questionable in successfully implementing this Provision in Fiscal Year 2005.
 4. Determined from a review of the LITS and inquiries with IRS management whether interim measures were being considered in instances in which there were problems in meeting due dates or when dates have been revised to later dates.
- II. Determined whether policies and procedures were established to ensure the IRS timely provided the necessary guidance to business taxpayers and practitioners to enable taxpayers to successfully comply with the tax law.

¹ Pub. L. No. 108-357, 118 Stat. 1418 (2004).

² The LITS is an IRS Intranet-based planning and monitoring system for implementation of tax legislation. It is designed to monitor legislation that has a significant impact on the IRS.

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

- A. Obtained information from IRS management with regard to the process or procedures developed to ensure necessary guidance and information were provided to taxpayers and/or practitioners. We determined whether the IRS can identify U.S. corporations that can or have received certain dividends from controlled foreign corporations that would be eligible for the 85 percent dividends received deduction.
 - B. Reviewed the two issued Notices (Notices 2005-10 and 2005-38) and related Fact Sheets that provided guidance for the reinvestment of foreign earnings in the U.S.
 - C. Reviewed the Practitioners' Guide to the Filing Season, Tax Talk Today, and the IRS E- News for Practitioners to determine whether information is being provided by the IRS to practitioners to enable them to ensure taxpayers are successfully complying with AJCA Provision 422.
 - D. Reviewed News Releases from the "In the News" section of the IRS web site (IRS.gov) on a daily basis regarding Provision 422 to identify any trends related to the guidance being provided.
- III. Determined whether the IRS timely developed and revised forms, schedules, instructions, or publications, when necessary.
- A. Contacted the Tax Forms and Publications Division and obtained the potential list of forms, instructions, and publications affected by the AJCA.
 - B. Identified the affected forms, instructions, and publications related to AJCA Provision 422.
 - C. Identified the stated changes required to the affected documents and the status of these changes.
 - D. Obtained and reviewed affected forms, instructions, and publications from the IRS web site to determine whether they were available on the web site and the stated required changes had been made to the affected documents. If forms were not available, we monitored the IRS web site to determine when the forms became available.
 - E. Contacted the IRS forms toll-free number, 1-800-829-3676, to request the tax forms affected by AJCA Provision 422. We determined whether the forms were available or needed to be "back ordered."
 - F. Contacted LMSB Division management to determine the status of the draft One-Time Dividends Received Deduction for Certain Cash Dividends from Controlled Foreign Corporations (Form 8895), proposed contents, status, and expected date of issuance.

**Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for
Reinvesting Foreign Earnings in the United States**

Appendix II

Major Contributors to This Report

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**Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for
Reinvesting Foreign Earnings in the United States**

Appendix III

Report Distribution List

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 Commissioner, Large and Mid-Size Business Division SE:LM
 Commissioner, Wage and Investment Division SE:W

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

Appendix IV

Management's Response to the Draft Report

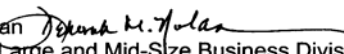


DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

AUG 29 2005

RECEIVED
SEP 02 2005

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Deborah M. Nolan 
Commissioner, Large and Mid-Size Business Division

SUBJECT: Draft Audit Report - Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States (Audit # 2005-30-008)

Thank you for the opportunity to respond to your draft audit report on the actions the Internal Revenue Service (IRS) has taken to implement Provision 422 of the American Jobs Creation Act of 2004 (AJCA),¹ Incentives to Reinvest Foreign Earnings in the United States. We appreciate your acknowledgment of the many actions we have taken, and those that we plan to take, to fully implement this complex provision of the Act. We respectfully disagree, however, with your evaluation of the record particularly regarding the timeliness of the relevant guidance, form, and instructions.

IRS' extraordinary efforts to expedite guidance, and issue the relevant form and instructions have met the challenge of facilitating compliance, under a complex statute, in an exceedingly short time frame. Potentially affected corporate taxpayers were heavily involved in the legislative process. Immediately after enactment, the IRS, its Office of Chief Counsel, and the Treasury's Office of Tax Policy designated guidance for this provision as a top priority item and made a significant staffing commitment, including having officials at the highest levels of those offices begin a coordinated outreach to both external and internal stakeholders in meetings, conferences, correspondence, and phone calls for purposes of identifying and prioritizing issues needing guidance under the new provision.

These offices focused on addressing those priority issue areas, and addressing them in the priority order that had been established in the course of their outreach to external and internal stakeholders. Thus, they targeted the issuance of three priority notices: the first primarily addressing domestic reinvestment plans and an administrative safe harbor, the second primarily addressing the effects of mergers and acquisitions, and the third primarily addressing computational issues.

Approximately three months after enactment of this provision, the IRS issued Notice 2005-10 on January 13, 2005 as well as a Fact Sheet. The Notice addressed multiple issues, including adoption, content and compliance for domestic reinvestment plans, the

¹ Pub. L. No. 108-357, 118 Stat. 1418 (2004).

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

2

kinds of investments in the U.S. for which the distributed dividends may be used under this program, definition of terms, and description of how taxpayers can elect to apply this section to the taxable year. Notably, the Notice included safe harbor provisions designed to facilitate compliance and administration both for taxpayers and IRS. This Notice was made available to major national and tax media companies and included on the IRS' Website.

On May 10, 2005, the IRS issued Notice 2005-38 to provide much anticipated direction on the effects of mergers, acquisitions, and reorganizations in calculating the amount of eligible dividends. It included detailed explanations of new rules on qualifying dividends, maximum repatriations, and related-party indebtedness. Illustrative of the intensive efforts of the IRS in issuing expedited priority guidance under this provision was its consideration, analysis, and expedited response to a significant volume of in-depth comments received in the short period leading up to the issuance of this second priority notice.

On May 12, 2005, the IRS made available to the public on the IRS' Draft Tax Forms Website a draft of Form 8895, One-Time Dividends Received Deduction for Certain Cash Dividends from Controlled Foreign Corporations, for taxpayers to elect and compute eligible dividends received deductions. In accordance with standard procedure, the timing of this issuance was coordinated with the expedited guidance in process so that the draft form was as close as possible to what was anticipated to be the final version of the form. This enabled interested parties to have confidence that the product was substantially similar to what would be the final version (made available to the public contemporaneously with Notice 2005-64, discussed below). Thus, since its May 12 posting, the draft Form 8895 has been available for taxpayers to calculate their eligible dividends received deductions, as well as to assist them in completing all portions of their corporate income tax returns that are affected by election under the provision.

On August 19, 2005, the third priority notice, Notice 2005-64, was issued to address computational issues relating to the foreign tax credit, allocation of deductions, currency translation, and the alternative minimum tax. Contemporaneous with the third notice, the final Form 8895 (unchanged from the draft of May 12, 2005) and instructions were made available to the public.

All three priority notices included liberal transition rules (e.g., allowing modifications of the dividend reinvestment plans, or filing amended returns to revise computations) in light of the additional guidance in those notices.

Taxpayers who needed to repatriate earnings for purposes of claiming the deduction for years beginning before enactment could not reasonably be provided meaningful guidance in that time window. In their case, the reasonable expectation was that they would take conservative positions under the statute and committee reports with the anticipation that the IRS would include flexible provisions in its issued guidance. Such taxpayers will likely file on extension. For example, in the case of a calendar year 2004

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

3

corporation, although the due date (excluding an extension) is March 15, 2005, the due date (including an extension) is September 15, 2005. The draft version of Form 8895 was made available more than four months in advance of the extension date. Moreover, as noted, the third in the series of priority notices and final form and instructions were issued before then. Any taxpayers that may have filed their returns earlier, before Form 8895 was made available in final form, are not required to file the form with an amended return. They only need to retain the information requested on the form and to make it available to the IRS upon request. However, those taxpayers may still be required to file amended Forms 1120 if their dividend received deductions, or other affected return items, were computed differently than as instructed in Notice 2005-64 and on Form 8895. Understandably, most taxpayers have typically delayed their repatriation pending the IRS completing its expedited series of notices providing the priority guidance. For the earliest of those filers (for example, a taxpayer with a fiscal year beginning on November 1, 2004), a return would not be due without regard to extensions until January 15, 2006.

In sum, the IRS has done an extraordinary job providing the relevant guidance, form, and instructions on a priority and timely basis. Except for the legislative proposal under recommendation 1, which we will not consider, all corrective actions to address the recommendations in the draft audit report have been completed by now. If you have any questions, please contact Robert H. Green at (202) 435-5000.

Attachment

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

Attachment

RECOMMENDATION 1:

The Commissioner, LMSB Division, should evaluate the impact of insufficient guidance on hindering taxpayers from taking the deduction in the earlier of the two taxable years or both taxable years and coordinate with Chief Counsel to elevate this matter to the Department of the Treasury. A determination needs to be made as to whether legislation is necessary to extend the time needed to ensure that corporate taxpayers have complete guidance to enable them to appropriately plan and receive the intended tax benefits for reinvesting their foreign earnings in the U.S.

CORRECTIVE ACTIONS:

This recommendation was based on the assumption that taxpayers have not been provided timely and sufficient guidance. As explained in our management response, the IRS has provided the relevant guidance, form, and instructions on a priority and timely basis. Moreover, extending the section 965 election for an additional year would have significant revenue implications that undoubtedly were already part of Congress' consideration in enacting the provision.

IMPLEMENTATION DATE: N/A

RESPONSIBLE OFFICIAL: N/A

CORRECTIVE ACTION(S) MONITORING PLAN: N/A

RECOMMENDATION 2:

The Commissioner, LMSB Division, should coordinate with responsible officials to ensure that Form 8895 and related instructions are issued as soon as possible.

CORRECTIVE ACTIONS:

The final Form 8895 and its related instructions were forwarded to IRS multi-media on August 18, 2005, for release to the public. Therefore, no implementation schedule is needed.

IMPLEMENTATION DATE: N/A

RESPONSIBLE OFFICIAL: N/A

CORRECTIVE ACTION(S) MONITORING PLAN: N/A

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

2

RECOMMENDATION 3:

The Commissioner, LMSB Division, should coordinate with responsible officials to ensure that guidance and instructions are provided with regard to filing amended returns to assist taxpayers in complying with Provision 422, when dividends received deductions have already been improperly taken or computed.

CORRECTIVE ACTIONS:

Complete guidance and instructions have already been provided to taxpayers in the three priority notices and the instructions for Form 8895, with regard to filing amended returns or other information for purposes of complying with section 965. Such guidance and instructions are described in detail below.

- **TAXPAYER HAS FILED ITS TAX RETURN AND HAS ELECTED SECTION 965 PRIOR TO THE ISSUANCE OF FORM 8895.**

1. **Section 965 election**

Section 7 of Notice 2005-10 provides that if the taxpayer intends to elect section 965 prior to the issuance of Form 8895, the election is to be made on a statement that is attached to the taxpayer's timely filed tax return. The instructions for the Form 8895 further provide that a corporation that has filed its return before Form 8895 was made available in final form need not file an amended tax return, but should retain the information requested on the form to make it available to the IRS upon request.

2. **Computations**

Notice 2005-64 sets forth guidance to address computational issues relating to the foreign tax credit, allocation of deductions, currency translation, and the alternative minimum tax. Section 11.02 of Notice 2005-64 states that a taxpayer that has filed its return for its section 965 election year may revise its computations or annual reporting to conform to the guidance in Notice 2005-64 on an amended return that is filed by December 31, 2005. Form 8895 requires taxpayers to apply some of the computational rules found in Notice 2005-64. Even though pursuant to Notice 2005-64 some taxpayers may be required to file amended tax returns, Notice 2005-64 and the instructions to Form 8895 make clear that any taxpayers that may have filed their returns before Form 8895 was made available in final form are not required to file Form 8895 with an amended return. They only need to retain the information requested on the form and to make it available to the IRS upon request.

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

3

- **TAXPAYER HAS FILED ITS TAX RETURN FOR THE ELECTION YEAR PRIOR TO JANUARY 13, 2005.**

Section 965 reporting requirements

Section 9.02 of Notice 2005-10 provides that a taxpayer that has filed its tax return for the election year prior to January 13, 2005 (date of issuance of the Notice), may satisfy the reporting requirements of sections 8.02(a), 8.03(c), or 8.04(c) of Notice 2005-10 on an amended return that is filed by the due date (including extensions) of the tax return for such taxable year.

- **DOMESTIC REINVESTMENT PLANS (DRIPS) APPROVED PRIOR TO THE ISSUANCE OF NOTICE 2005-10 (JANUARY 13, 2005), NOTICE 2005-38 (MAY 10, 2005), OR NOTICE 2005-64 (AUGUST 19, 2005).**

All three of the Notices issued provide guidance about DRIPS. All three notices provide transition rules that allow taxpayers two months from the date of issuance of each notice to conform their DRIPS to the guidance provided in the respective notice.

Specifically, section 9.02 of Notice 2005-10 provides that DRIPS approved prior to January 13, 2005, that are not in conformity with the guidance provided in that notice may be modified to comply with the DRIP guidance in the notice not later than March 14, 2005. Section 11.01 of Notice 2005-38 provides a similar rule for DRIPS that need to be modified to take into account guidance provided in that notice. Such modifications must be completed no later than July 11, 2005. Finally, section 11.01 of Notice 2005-64 allows taxpayers until October 19, 2005 to modify their DRIPS to conform to guidance provided in that notice.

The DRIPS can be modified even if the dividends to which the plan relates have already been paid. The modified DRIPS 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, as provided by section 965.

- **TAXPAYER WANTS TO ELECT TO USE THE FAIR MARKET VALUE METHODOLOGY PURSUANT TO SECTION 9.05 OF NOTICE 2005-38, AND THE TAXPAYER HAS FILED IT TAX RETURN PRIOR TO MAY 10, 2005.**

Actions Are Needed to Ensure Corporations Receive Intended Tax Benefits for Reinvesting Foreign Earnings in the United States

4

Section 11.02 of Notice 2005-38 provides that if, prior to May 10, 2005, a taxpayer has filed its tax return for the taxable year for which its acquires an interest in a business entity that qualifies, in whole or in part, as a permitted investment, such taxpayer can elect to use the fair market value methodology pursuant to section 9.05 of Notice 2005-38 with respect to such acquisition on an amended return that is filed on or before December 31, 2005.

IMPLEMENTATION DATE: N/A

RESPONSIBLE OFFICIAL: N/A

CORRECTIVE ACTION(S) MONITORING PLAN: N/A