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THE
CFO'S
NEW LEGAL HOTSEAT



More than any other non-legal executive, the CFO historically has been charged with ongoing legal responsibilities, and today that role is expanding. In this special focus section, Executive Counsel will look at that role from a variety of perspectives. We've been privileged to have editorial board member Jerome Libin of the law firm Sutherland Asbill & Brennan to share his wisdom and experience on matters pertaining to the CFO's growing charge, and we would like to thank him and Sutherland Asbill for their support on this special focus.

The CFO's New Legal Hot Seat

Introduction from Sutherland Asbill & Brennan

Today, the expanded legal role of CFOs is driven in part by the passage of the Sarbanes-Oxley Act, which requires CFOs to personally certify that public representations made by the company are accurate.

At the same time, businesses face generally increased regulatory requirements on many fronts. Inevitably these requirements have financial implications, and often the CFO's judgment may be called upon to help chart a course of action with legal as well as financial implications. Even at companies that have in-house general counsel, today's CFO must remain informed about percolating legal concerns.

According to Jerome Libin, chair of our tax group, the broadening CFO role is becoming the rule rather than the exception. "CFOs generally have been responsible for tax matters and have had to address the legal issues affecting corporate tax liability," he says. "But now CFOs have other legal responsibilities to consider."

"It's a broad and sweeping responsibility," says Brian C. James, executive vice president, CFO and treasurer at the ADE Corp., a Nasdaq-traded semiconductor equipment manufacturer. James is part of a two-person executive team at ADE. He and the CEO make all major business and strategic decisions. The executive management team looks to in-house counsel to frame developing legal issues and alternative solutions, James says, but he and the CEO make the business calls regarding legal issues, often including the decision as to whether to bring in outside counsel.

GROWTH ADDS TO LEGAL WORKLOAD

Current economic conditions are adding to the legal challenges faced by many CFOs. As businesses try to leverage improved economics into growth opportunities, CFOs find themselves having to negotiate the thicket of legal and regulatory issues that come with acquisitions or expansion into new markets.

"If you're a CFO, the things you're looking for are a way to grow and a way to reduce your costs," says Bruce Nolop, executive vice president and CFO of Pitney Bowes, Inc. "Both of those can be affected by the increasingly activist legal environment."

On the strategic side, Nolop has served as the main architect for \$1.1 billion in corporate acquisitions, in a company that had more than \$4.5 billion in sales in

2003. On the operations side, his responsibilities include executive oversight of all legal issues.

Nolop, who is himself an attorney, works with in-house counsel to stay abreast of legal issues, which typically include corporate governance, liability and risk, and regulation – particularly postal regulations that impact the Pitney Bowes core business of postage products and services. Matters in which outside counsel are retained are typically channeled through in-house counsel, he says. On governance issues, he also works with the corporate secretary.

Even with all this support, the legal component of his own strategic decision-making is growing dramatically, according to Nolop. "There are many days I am very happy that I have a law degree," he says.

Robert Mahan, CFO of Ajilon Professional Staffing, says his primary role is managing the company's growth as recession ends and economic expansion picks up. He says he can rely on parent Adecco SA, which bills itself as the largest human resources capital company, with approximately \$20 billion in sales, for support in many legal areas, such as governance and Sarbanes-Oxley compliance.

However, he has been pulled into an increasing number of legal issues at the state level, as they affect Ajilon's expansion plans. "States are enacting legislation to generate revenue to cover budget deficits," he says.

He notes, for example, New Jersey recently enacted a \$3 fee per employee, effective retroactively for all employees on payroll since the beginning of 2003. "For the staffing industry, that's huge, because the temps are on our books," he says.

RETURN OF DISCIPLINE

To be sure, corporate governance issues spurred by Sarbanes-Oxley continue to top the list of regulatory concerns dominating CFO time and attention. "It's brought back a discipline to the auditing process that was missing for years," Mahan says.

The requirement that CFOs personally certify the accuracy of public company reports has forced this group to delve into a level of detail regarding company accounting, legal compliance, and even operations that often was delegated further down the chain of command.

But that discipline comes at a price. Many CFOs,

who face competing concerns to stay focused on top-level strategic concerns, feel pulled in opposite directions.

“Sarbanes created a need for a chief accounting officer,” says Mahan.

According to Mahan, Sarbanes-Oxley puts so much emphasis on controls documentation that if it weren’t for the support he receives from Adecco, he would have trouble focusing on strategic growth issues. “I can’t manage both of those roles,” he says.

“Under Sarbanes-Oxley,” says Hoshi Printer, executive vice president and CFO of Autobytel Inc., a \$120 million online automotive buying services company, “I have the responsibility to ensure that the company in fact follows what we claim we are.”

Printer sees his job as roughly organized into four quadrants: financial duties including auditing and risk management; operations responsibilities involving expansion and delivery of products and services; investment community communications; and strategic activities such as fund raising, mergers and acquisitions and moving into new businesses.

Printer works closely with Autobytel’s general counsel to manage legal issues. But he recognizes the need to be involved personally with the company’s most pressing concerns.

“My role is to ensure that we meet all legal requirements,” Printer says. “I need to comprehend the issues quite extensively.”

Two chief concerns right now are privacy and spam, he says, so he spends time overseeing representations the company makes on its Web site and to automobile dealers.

The demands of Sarbanes-Oxley also require CFOs to spend more time interfacing with investors, the board of directors, the audit committee, and both in-house and outside counsel.

“I’m communicating and working with the board of directors much more than in the past,” says Nolop of Pitney Bowes. He and his team make sure acquisition strategies are fully vetted with the board, and that company governance procedures pass muster in the new environment.

PRIVATE COMPANY CONCERNS

Although the mandates of Sarbanes-Oxley are aimed at public companies, CFOs at private companies are also feeling the pressure to comply with heightened corporate governance mandates.

“We are planning to become Sarbanes-Oxley-compliant, partially because we plan to go public someday, but also because it’s a good standard of corporate governance,” says Carl Byers, CFO of athenahealth, Inc., a privately-held medical billing services and software company based in Waltham, Mass.

The demands of Sarbanes-Oxley require CFOs to spend more time interfacing with investors, the board of directors, the audit committee, and both in-house and outside counsel.

This has meant paying greater attention to how and what information is disclosed. “In our case, when there are tricky transactions, we often go to our auditors before the transactions occur, to make sure we’re on the same page as to how we book it,” Byers says. “I think it’s good to be proactive.”

In companies that fail to meet accounting standards, CFOs can quickly find themselves enveloped in legal issues.

Michael Rodriguez, CFO and senior vice president of Endocare, Inc., a California-based medical device manufacturer, is part of a new management team brought on to help resolve accounting investigations by the SEC and the Department of Justice.

In 2002, the company failed to file a quarterly report with the SEC. The outside auditor withdrew its opinion, the stock was delisted from the NASDAQ, and the company faced a proxy battle and potential shareholder lawsuits. Building a strong financial reporting process and internal controls became management’s top priority.

By hiring a new management team and focusing on governance, the company was able to keep its customer base, avoid a proxy battle and settle several lawsuits. Endocare, which now has revenue of approximately \$30 million, is in the process of finalizing the SEC and DOJ investigations, Rodriguez says.

The experience has put the CFO front and center of corporate legal issues at Endocare. “Our main goal,” says Rodriguez, in a summation that speaks for a lot of CFOs these days, “is to make sure everyone is up to speed on issues that are or may become legal.”

Sutherland Asbill & Brennan thanks journalist Richenya A. Dodd for help in preparing this article.



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Ambiguous Amnesty in the Jobs Creation Act

New Tax Law Repatriation Provision Gives CFOs Much to Chew On

By Jerome B. Libin and John L. Hynes

Temporary relief from U.S. tax on repatriated foreign earnings has been provided as part of the American Jobs Creation Act of 2004, signed by President Bush on October 22. The temporary incentive gives multinationals, under certain circumstances, a unique one-time opportunity to repatriate foreign earnings on a tax-efficient basis.

But many taxpayers will face a number of uncertainties and potential pitfalls when attempting to take advantage of it. While the concept underlying the new provision appears relatively simple, its implementation is likely to be quite complex, in part due to last-minute changes made by Congress. As a result, there are a variety of issues that CFOs and their tax departments must consider before taking action.

Here (complete with acronyms) are some highlights of the new legislation, and some things a company needs to keep in mind if it is considering taking advantage of the new law and its potentially considerable benefits.

SCOPE OF “ELECTION”

In general, the new law gives a U.S. corporation an opportunity to elect, for a single taxable year, the benefit of a “temporary dividends received deduction” (temporary DRD) equal to 85 percent of the “cash

dividends” it receives during that year from its foreign subsidiaries (controlled foreign corporations, or CFCs) in excess of its average repatriation amount.

In general, the total amount eligible for the temporary DRD is limited to the greater of \$500 million or the taxpayer’s “permanently reinvested” foreign earnings (determined in one of two ways). The election may be made by the U.S. parent company either for its last taxable year beginning before October 22, 2004, or for its first taxable year beginning on or after that date and before October 22, 2005.

Again, new Internal Revenue Code section 965(a) provides the temporary DRD only with respect to “cash dividends.” The provision generally excludes non-cash dividends, such as “deemed dividends” of deferred earnings triggered by certain transactions involving the stock of foreign corporations and income inclusions required under Subpart F of the Code.

Importantly, however, the provision permits cash dividends to be paid up a chain of controlled foreign corporations to the U.S. shareholder despite the dividend being considered subpart F income upon receipt by a higher-tier CFC. Also, in the case of an inbound liquidation of a foreign subsidiary that involves both a deemed dividend income inclusion and the actual

receipt of cash by the U.S. parent company, the temporary DRD will be available to the extent of the cash actually received by the U.S. parent.

DIVIDENDS MUST BE EXTRAORDINARY

The temporary DRD is available only with respect to that part of a U.S. parent's election year cash dividends from CFCs that exceed its "base period average" repatriation amount (i.e., the temporary DRD is available only with respect to "extraordinary" dividends).

The base period consists of the last five tax years ending on or before June 30, 2003, with the high and low repatriation years excluded. The major point to note here is that the base period average calculation includes certain amounts that are excluded from the election year calculation. Specifically, the base period average includes section 956 inclusions and distributions of previously taxed income, whether or not attributable to current year dividends, even though such amounts are not counted toward overcoming the base period average in the election year.

For many taxpayers, the result could be a relatively high base period average that will need to be exceeded before a dividend is eligible for the temporary DRD. In such cases, dealing with the base period average may require careful planning, particularly where both high-tax and low-tax earnings must be repatriated in order to exceed the base period average, as discussed further below.

While the concept underlying the new provision appears relatively simple, its implementation is likely to be quite complex, in part due to last-minute changes made by Congress.

DOMESTIC REINVESTMENT - PERMITTED USES

The U.S. parent making the election must establish a "domestic reinvestment plan" for all cash dividends eligible for the temporary DRD. The plan must be approved by the president or chief executive officer before the dividends are paid, and must also subsequently be approved by the board of directors. Only certain types of expenditures qualify as permitted domestic reinvestment. Section 965(b)(4) lists, as examples of permitted uses, the funding of worker hiring and training, infrastructure, R&D, capital investments, and "financial stabilization...for the purposes of job retention or creation." The one explicit non-permitted use is for the payment of executive compensation.

The "financial stabilization" category has generated much discussion because the statutory language is

vague. The phrase "financial stabilization" would suggest debt repayment, at least in certain circumstances, but the link to "job retention or creation" is less clear. In addition, even if pure debt repayment is contemplated by the term, there is an issue as to whether a company could rely on this if it has a very low debt-to-equity ratio and the repayment of debt has no effect on its credit rating. Would debt repayment in such a case constitute "financial stabilization"?

Delineating the permitted uses of repatriated funds should be one of the top priorities for guidance from Treasury. However, Congress declined to provide further clarification of the permitted uses and it is possible that Treasury will do the same. In the absence of such guidance, the law's legislative history might provide some basis for determining whether "financial stabilization" should be interpreted to include, for example, stock buybacks or the payment of shareholder dividends.

DOMESTIC REINVESTMENT - TRACING REPATRIATED FUNDS

There is no requirement that the taxpayer's "domestic reinvestment" spending must be incremental compared to what it had invested during prior years or compared to its pre-legislation plans for the election year. Furthermore, there is no explicit requirement that taxpayers trace the repatriated cash to the specific uses set forth in the domestic reinvestment plan. However, the policy objective of stimulating the U.S. economy suggests that

Congress at least presumed that the provision would lead to incremental spending. It is not clear whether Treasury and the IRS will seek to impose some kind of tracing requirement in order to enforce the policy objective, and if so, what authority Treasury would cite

as the basis for such a requirement.

In addition to uncertainty regarding incremental spending and tracing of cash, the provision does not specifically address whether the expenditures may be made over a period of years. The time frame for spending may be particularly relevant in the case of capital investments, as would any consequences if a reinvestment plan must be altered or terminated in mid-course. These uncertainties would suggest that it is preferable to establish a broad plan setting forth as many permitted uses as possible, and with flexibility as to allocation among such uses over a reasonable period of time under the circumstances.

FUNDING

In general, the legislation contains no restrictions on off-

shore external or internal borrowing by a CFC to fund dividends covering the base period amount or to produce dividends eligible for the temporary DRD. However, a provision added by the conference committee requires that the taxpayer reduce its cash dividend amount eligible for the deduction by the amount of any increase in overall CFC debt to related parties between October 3, 2004 and the close of the taxpayer's election year. Although this provision was intended to prevent a round trip of cash from the United States, it raises various technical issues and may require planning to manage certain legitimate and entirely unrelated transactions, such as license arrangements and sales of property that give rise to intercompany payables.

It also raises questions as to funding techniques that fall outside the statute but that would appear to violate the policy of requiring net repatriation (e.g., funding the CFC dividend through an equity injection of cash from the United States).

EXPENSE DEDUCTION ALLOCATION AND APPORTIONMENT

In another provision added at the eleventh hour by the conference committee, the legislation denies any deduction for expenses "properly allocated and apportioned to the deductible portion" of the cash dividends. On its face, this provision raises a wide variety of issues and could materially reduce the repatriation benefit for many taxpayers. Colloquies on the floor of the House and Senate before final passage of the legislation suggest a narrower, although still somewhat ambiguous, meaning.

Senator Grassley stated, for example, that the provision was intended to refer only to "directly related" expenses, and listed stewardship costs and directly related legal and accounting fees as examples of costs that should be "properly allocated and apportioned."

FOREIGN TAX CREDIT CONSIDERATIONS

One of the most significant elements of the legislation for planning purposes is the denial of foreign tax credits for the deductible portion of the cash dividends, including any withholding taxes paid in order to repatriate the dividends.

In appropriate circumstances, planning opportunities may be available to eliminate withholding tax (for example, through cross-chain "section 304" stock sales), thereby minimizing the loss of credits on the deductible portion of the dividends. However, there is an issue as to whether there may be an averaging down of high-tax earnings with low-tax earnings as taxpayers repatriate high-tax earnings to overcome the base period average and low-tax earnings to benefit from the temporary DRD. The conference report Statement of Managers states that taxpayers may identify which

dividends cover the base period amount and which are treated as in excess of such amount.

Logically, taxpayers would designate high-tax earnings to overcome the base period average amount and use low-tax earnings to qualify for the temporary DRD, but it is not clear what effect this designation has on the foreign tax credit rules that normally apply as earnings are paid through a chain of foreign corporations. Until further guidance is issued, uncertainty will exist regarding the most effective ways to maximize the use of available foreign tax credits in this context.

It is unclear whether new section 965 contemplates that the U.S. parent must include in income the so-called section 78 "gross up" amount allocable to the deductible portion of its eligible cash dividends received, notwithstanding that the legislation expressly disallows use of the related foreign tax credits. Any such requirement would seem to be a technical glitch, and there have been informal indications from congressional tax staff that the result is indeed unintended.

Inclusion of the section 78 amount would increase the cost of repatriation under section 965 and could determine whether or not it would be beneficial to apply the new provision to a particular pool of earnings. An IRS official has recently stated that the issue will definitely be receiving consideration.

CFOs hoping to take advantage of the unique repatriation opportunity in this law will need to review all relevant facts and make careful judgments on a variety of legal issues. That burden will be reduced somewhat if helpful guidance from the IRS is forthcoming in the not-too-distant future. A senior IRS official has recently stated that issuing such guidance is a high priority.



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