

August 31, 2018

Proposed Section 965 Regulations

Proposed Regulations Follow Earlier Guidance With Modifications and Additions

SUMMARY

On August 1, 2018, the Internal Revenue Service (the “IRS”) and the Treasury Department (“Treasury”) issued Proposed Regulations (the “Proposed Regulations”) on Section 965 of the Internal Revenue Code (the “Code”). Prior to passage of the comprehensive tax reform bill commonly known as the Tax Cuts and Jobs Act of 2017 (the “Act”)¹ in December 2017, the United States had a “global” system of international taxation, wherein earnings from foreign subsidiaries of U.S. corporations were generally subject to U.S. tax when distributed to the U.S. parent, subject to credits for foreign taxes paid on such earnings. This system incentivized U.S. corporations to retain earnings offshore, to avoid paying additional U.S. tax on such earnings. The Act adopted a new “territorial” system, wherein a U.S. corporation that owns 10% or more of a foreign corporation is generally entitled to a 100% dividends-received deduction for, and therefore an exemption from further U.S. tax on, dividends paid by such foreign subsidiaries.

Section 965, enacted as part of the Act, ensures that the previously untaxed offshore earnings of U.S. corporations are not lost to the U.S. tax system because of the change from a global to a territorial system. This is accomplished by levying a one-time “transition tax” on the post-1986 untaxed foreign earnings of certain specified foreign corporations owned by 10% United States shareholders (“U.S. Shareholders”). Untaxed foreign earnings held in the form of cash or cash equivalents are taxed at an effective rate of 15.5%, and earnings held in any other form are taxed at an 8% effective rate. Taxpayers who must pay the transition tax may generally elect to do so over an eight-year period.

This memorandum provides an overview of the Proposed Regulations, focusing on the clarifications and changes from the interim notices. It is noteworthy that the government generally declined in the Proposed Regulations to simplify or liberalize its prior positions.

INTERIM GUIDANCE

Following the passage of the Act in December 2017, the IRS and Treasury issued several Notices announcing regulations intended to be issued under Section 965.ⁱⁱ Each of these Notices provided guidance in order to clarify and elaborate on a number of issues related to Section 965 left unclear by the statute. For example, the Notices focused on resolving a variety of situations where double-counting of income or cash could arise. The Notices in some cases provided mechanical rules for computation of the inclusion (including how deficits would be taken into account) and clarified the interaction of these new computations with the existing rules related to “previously taxed income” and associated basis adjustments.

The Notices also covered currency adjustments and allocations of foreign income taxes. In addition, the Notices provided rules governing the treatment of shares held by partnerships for purposes of determining whether a foreign corporation is a specified foreign corporation and identifying 10% U.S. Shareholders.

Finally, the Notices set out anti-abuse rules to prevent taxpayers from entering into certain transactions that could reduce their Section 965 inclusions.

In addition to the Notices just described, the IRS also released Rev. Proc. 2018-17, which modified the circumstances under which the IRS grants automatic approval of requests by foreign corporations for changes to their annual accounting periods. The modification prevented specified foreign corporations with U.S. Shareholders that would have a Section 965(a)(1) inclusion and with taxable years ending on December 31 from changing their annual accounting period to a period that would end before December 31, 2017. This modification prevented U.S. Shareholders of such specified foreign corporations from delaying, roughly by one year, the Section 965 inclusion, which is imposed on the last taxable year of a specified foreign corporation that begins before January 1, 2018. Rev. Proc. 2018-17 is not discussed in the Proposed Regulations and is therefore not affected by the Proposed Regulations.

THE PROPOSED REGULATIONS

The Proposed Regulations primarily follow through on the stated intent of the earlier guidance and reiterate the rules related to Section 965 described in the earlier guidance. However, a few important modifications and additions were made. This memorandum summarizes the rules contained in the Proposed Regulations, emphasizing the rules that diverge from those laid out in the earlier guidance.

Definitions and General Rules (Section 1.965-1)

Notable general rules:

- Because an increase in subpart F income by reason of Section 965(a) is generally determined after subpart F income is otherwise determined under Section 952, neither the Section 965(a) earnings amount nor the Section 965(a) inclusion amount is subject to the rules/limitations of

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Section 952 or otherwise limited by the accumulated earnings and profits (“E&P”) of the DFIC (as defined below) on the date of inclusion (which in some cases could be 11 months after the applicable measurement date) (1.965-1(b)(1)).

- If a Section 958(a) U.S. Shareholder is a member of a consolidated group, all Section 958(a) U.S. Shareholders in that group are treated as a single Section 958(a) U.S. Shareholder for purposes of calculating the shareholder’s aggregate foreign E&P deficit and using it to offset the shareholder’s Section 965(a) inclusion amount (1.965-1(b)(2)).
- The Proposed Regulations expand the rule in Section 2.13 of Notice 2018-26 to provide that for purposes of identifying Section 958(a) U.S. Shareholders of specified foreign corporations (and not just those that are controlled foreign corporations within the meaning of Section 957(a) (“CFCs”)) and the Section 958(a) stock held by such shareholders, a domestic partnership is treated as a foreign partnership if certain conditions are satisfied (1.965-1(e)(1)). This rule prevents a domestic partnership from recognizing the inclusion only to allocate it to foreign corporate partners that do not pay U.S. tax on such inclusion.

Notable definitions:

- Consistent with Section 3.02(c) of Notice 2018-07, the Proposed Regulations provide that in the case of a CFC that has shareholders that are not U.S. Shareholders on an E&P measurement date, the “accumulated post-1986 deferred foreign income” of the CFC on such E&P measurement date is reduced by amounts that would be described in Section 965(d)(2)(B) if those shareholders were U.S. Shareholders. In such cases, the principles of Revenue Ruling 82-16 apply in order to determine the amounts by which accumulated post-1986 deferred foreign income is reduced (1.965-1(f)(7)(i)(C)). The goal of this rule is to allocate income that would, when distributed, be distributed to shareholders that are not U.S. Shareholders to those non-U.S. Shareholders in order to avoid overstating the inclusion amounts for U.S. Shareholders.
- The Proposed Regulations define a specified foreign corporation as either (i) a CFC or (ii) a foreign corporation of which one or more domestic corporations is a U.S. Shareholder. The definition excludes foreign corporations that are passive foreign investment companies but not CFCs with respect to a U.S. Shareholder, and (consistent with Section 3.01 of Notice 2018-26) modifies the otherwise applicable attribution rules by preventing attribution from a partner to a partnership if the partner owns a less than 5% interest in the partnership (taking into account any partnership interests otherwise attributed to such partner) (1.965-1(f)(45)). A deferred foreign income corporation (“DFIC”) is generally any specified foreign corporation that has accumulated post-1986 deferred foreign income greater than zero as of an E&P measurement date (1.965-1(f)(17)).
- Consistent with Section 3.02(b) of Notice 2018-07, the definition of “post-1986 earnings and profits” clarifies that such earnings are only reduced to account for distributions made from one specified foreign corporation to another specified foreign corporation to the extent that the post-1986 earnings and profits of the recipient specified foreign corporation are increased on account of such distribution (1.965-1(f)(29)(i)(B)).
- Consistent with Section 3.03 of Notice 2018-26, the definition of “post-1986 earnings and profits” provides that any foreign income taxes that accrued after November 2, 2017 (the first E&P measurement date) but on or before December 31, 2017 (the second E&P measurement date), and within the specified foreign corporation’s U.S. taxable year that includes November 2, 2017, will reduce such earnings as of November 2, 2017 by the amount of such taxes attributable to the foreign income that accrued on or before November 2, 2017 (1.965-1(f)(29)(ii)).ⁱⁱⁱ
- Comments noted that a specified foreign corporation that is not a CFC does not calculate its E&P for U.S. federal income tax purposes, but the Proposed Regulations nevertheless decline to provide alternative methods for determining a corporation’s E&P or cash position.
- Although comments requested a number of modifications to the definition of accounts payable in Section 3.04(a) of Notice 2018-13, Treasury declined these requests (stating that “accounts

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payable” is not defined in the statute, and that Treasury and the IRS believe the definition in the Proposed Regulations to be “consistent with the ordinary meaning of accounts payable”).

- The Proposed Regulations clarify that an instrument’s term upon issuance is used for purposes of determining whether an obligation is a short-term obligation (1.965-1(f)(43)), but the Proposed Regulations decline to include a facts-and-circumstances test to determine when and whether a demand loan should not be treated as a short-term obligation.
- The Proposed Regulations define the term “pro rata share,” with respect to a Section 958(a) shareholder of a specified foreign corporation, a DFIC, or an E&P deficit corporation, as follows:
 - With respect to the Section 965(a) earnings amount of a DFIC, the pro rata share is the portion of Section 965(a) earnings amount that would be treated as distributed to the U.S. Shareholder under Section 951(a)(2)(A) and Treasury Regulations Section 1.951-1(e), determined as of the last day of the inclusion year of the DFIC (1.965-1(f)(30)(i)).
 - Consistent with Section 3.03(a) of Notice 2018-13, the Proposed Regulations clarify that the specified E&P deficit is allocated among the shareholders of the corporation’s common stock in proportion to the value of the common stock held by such shareholders (1.965-1(f)(30)(ii)). Comments are requested regarding whether, in what circumstances, and how such deficit may also be allocated to shareholders of the corporation’s preferred stock.
 - The pro rata share of the cash position of a specified foreign corporation on a cash measurement date is the portion of the cash position that would be treated as distributed to the U.S. Shareholder under Section 951(a)(2)(A) and Treasury Regulations Section 1.951-1(e) if the cash position were subpart F income, determined as of the close of the cash measurement date and without regard to whether the U.S. Shareholder is a U.S. Shareholder of the specified foreign corporation as of any other cash measurement date of the specified foreign corporation (1.965-1(f)(30)(iii)).

Adjustments to E&P and Basis (Section 1.965-2)

Section 1.965-2 of the Proposed Regulations includes certain rules regarding adjustments to E&P and adjustments to basis. The rules on adjustments to E&P are logical corollaries of the general calculation rules under Section 965. Some notable rules regarding adjustments to basis are as follows:

- Rules relating to basis adjustments are reserved where a Section 962 election has been made by a U.S. individual to be taxed at corporate rates on his or her income inclusions under Section 951(a) and to be treated as a domestic corporation for purposes of taking into account deemed paid foreign taxes under Section 960.
- In general, no adjustments to the basis of stock or property are made under Section 961 (or any other provision of the Code) to take into account the reduction to a U.S. Shareholder’s pro rata share of the Section 965(a) earnings amount of a DFIC in respect of the DFIC’s allocable share of the U.S. Shareholder’s aggregate foreign E&P deficit. However, the Proposed Regulations allow taxpayers to elect to (i) increase the Section 958(a) U.S. Shareholder’s basis in Section 958(a) stock of a DFIC or applicable property with respect to a DFIC by an amount equal to the Section 965(b) previously taxed earnings and profits of the DFIC with respect to the shareholder, and (ii) reduce the Section 958(a) U.S. Shareholder’s basis in an E&P deficit corporation or applicable property with respect to an E&P deficit corporation by an amount equal to the portion of the shareholder’s pro rata share of the specified E&P deficit taken into account under the reduction rules, but only if such Section 958(a) U.S. Shareholder consistently makes all of the relevant basis adjustments (1.965-2(f)(2)).

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Section 965(c) Deductions (Section 1.965-3)

- Section 1.965-3 of the Proposed Regulations provides rules for calculating the deductions required to arrive at the effective rate of 15.5% on untaxed foreign earnings held as cash or cash equivalents, and at the 8% effective rate on untaxed foreign earnings held in any other form.
- The Proposed Regulations contain certain rules to avoid the double-counting of assets in calculating a Section 958(a) U.S. Shareholder's pro rata share of the cash position of a specified foreign corporation (1.965-3(b)(1)-(2)).
- The Proposed Regulations also contain rules for how to allocate a Section 958(a) U.S. Shareholder's aggregate foreign cash position over multiple Section 958(a) U.S. Shareholder inclusion years (1.965-3(c)(2)).

Disregard of Certain Transactions (Section 1.965-4)

Consistent with Section 3.04 of Notice 2018-26, Section 1.965-4 of the Proposed Regulations includes anti-avoidance rules that disregard certain transactions. It is noteworthy that these transactions are disregarded only for Section 965 purposes, with the result that they may continue to have other tax effects. These rules largely follow those that were announced in Notice 2018-26, with two notable exceptions:

- The anti-avoidance rules announced in Notice 2018-26 were based on whether there was a change in the amount of a "Section 965 liability." The rules in the Proposed Regulations, on the other hand, are based on whether there is a change in the amount of a "Section 965 element." A "Section 965 element" is then defined to include a U.S. Shareholder's Section 965(a) inclusion amount with respect to a specified foreign corporation; the aggregate foreign cash position of the U.S. Shareholder; and the amount of foreign income taxes of a specified foreign corporation deemed paid by the U.S. Shareholder under Section 960 as a result of a Section 965(a) inclusion. Despite the difference in terminology, the definitions of the Notice and the Proposed Regulations both essentially include: (i) a reduction in the U.S. Shareholder's Section 965(a) inclusion amount with respect to a specified foreign corporation, (ii) a reduction in the aggregate foreign cash position of the U.S. Shareholder (but only if such amount is less than the U.S. Shareholder's aggregate Section 965(a) inclusion amount), and (iii) an increase in the amount of foreign income taxes of a specified foreign corporation deemed paid by the U.S. Shareholder under Section 960 as a result of a Section 965(a) inclusion (1.965-4(d)). Any transaction taken after November 2, 2017 with a principal purpose of having one of the above effects and which does have such an effect is disregarded (1.965-4(b)(1)).
- Section 1.965-4(f) of the Proposed Regulations disregards certain "specified payments" (see discussion below).

The Proposed Regulations follow Section 3.04 of Notice 2018-26 in presuming that certain transactions are undertaken with a principal purpose of reducing a Section 965 element (or Section 965 tax liability) of a U.S. Shareholder (1.965-4(b)(2)(i)). The presumption may be rebutted only if facts and circumstances clearly establish that the transaction was not undertaken with a principal purpose of changing the amount of a Section 965 element of a U.S. Shareholder, and a taxpayer taking the position that the presumption is rebutted must attach a statement to its tax return disclosing that it has rebutted the presumption. In addition, certain transactions are treated "per se" as being undertaken with a principal purpose of reducing a Section 965 element. Taxpayers cannot rebut the application of these "per se" rules, and accordingly transactions treated "per se" as being undertaken with a principal purpose of reducing a Section 965 element are disregarded if the transactions occurred, in whole or in part, on or after

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November 2, 2017, and the transactions did in fact change the amount of a Section 965 element of the U.S. Shareholder. Transactions subject to the presumption include:

- certain transactions between a specified foreign corporation and its U.S. Shareholder (or a related person) that would reduce the aggregate cash position of the U.S. Shareholder (“cash reduction transactions”) (1.965-4(b)(2)(iii)(A)). Certain cash reduction transactions that are distributions are treated per se as being undertaken with the principal purpose of changing the amount of a Section 965 element of a U.S. Shareholder (“specified distributions”) (1.965-4(b)(2)(iii)(B));
- certain transactions (that do not occur in the ordinary course of business) between a specified foreign corporation and a U.S. Shareholder (or another specified foreign corporation or related person of the U.S. Shareholder) that would reduce either the accumulated post-1986 deferred foreign income or the post-1986 undistributed earnings of the specified foreign corporation or of another specified foreign corporation or one of its U.S. Shareholders (“E&P reduction transactions”) (1.965-4(b)(2)(iv)(A)). Certain E&P reduction transactions that include (i) a complete Section 331 liquidation of a specified foreign corporation, (ii) a sale or other disposition of stock by a specified foreign corporation, or (iii) a distribution by a specified foreign corporation that reduces the E&P of the specified foreign corporation under Section 312(a)(3) (all, a “specified transaction”) are treated per se as being undertaken with a principal purpose of changing the amount of a Section 965 element of a U.S. Shareholder (1.965-4(b)(2)(iv)(B)); and
- certain transfers of stock of a specified foreign corporation if such transfer would reduce the relevant U.S. Shareholder’s pro rata share of the Section 965(a) earnings amount of the specified foreign corporation, and/or reduce the U.S. Shareholder’s pro rata share of the cash position of the specified foreign corporation (a “pro rata share reduction transaction”) (1.965-4(b)(2)(v)(A)(1)), and certain transfers of the stock of an E&P deficit corporation if the transfer would increase the relevant U.S. Shareholder’s pro rata share of the specified E&P deficit of the E&P deficit corporation (an “E&P deficit transaction”) (1.965-4(b)(2)(v)(A)(2)) (collectively, “pro rata share transactions”). Certain pro rata share transactions are treated per se as being undertaken with a principal purpose of changing the amount of a Section 965 element of a U.S. Shareholder if, immediately before or after the transfer, the transferor and transferee are members of an affiliated group in which the U.S. Shareholder is a member (an “internal group transaction”) (1.965-4(b)(2)(v)(B)).

The Proposed Regulations also disregard certain changes in accounting methods and entity classification elections where such change would change the amount of a Section 965 element, regardless of whether the change is made with a principal purpose of changing the amount of a Section 965 element with respect to a U.S. Shareholder (1.965-4(c)(1)-(2)).

Finally, the Proposed Regulations disregard any “specified payment” made from one specified foreign corporation to another specified foreign corporation in between the two measurement dates (November 2, 2017 and December 31, 2017) for purposes of calculating the post-1986 earnings and profits of each specified foreign corporation as of December 31, 2017. A “specified payment” is a payment:

- where the payor and payee are related within the meaning of Section 954(d)(3) (substituting the term “specified foreign corporation” for “controlled foreign corporation”);
- where the payor and payee do not have the same “tentative E&P measurement date” (the E&P measurement date that would result in the greater amount of accumulated post-1986 deferred foreign income);

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- where the payment or accrual of the amount occurs after November 2, 2017 and on or before December 31, 2017; and
- where the payment would reduce the post-1986 earnings and profits of the payor as of December 31, 2017.

Section 1.965-4(f)(4) lays out several examples of “specified payments,” which include:

- a deductible payment from one CFC to its 100% shareholder (or to its 51% shareholder), which is also a CFC; and
- a distribution from one CFC to its 100% shareholder, which is also a CFC.

Section 1.965-4(f)(4) also includes examples of transactions that are not “specified payments,” including:

- a deductible payment from one CFC to its 50% shareholder, which is also a CFC; and
- a CFC’s deductible payment to or income accrued from an unrelated person.

There were a number of comments in response to Section 3.04 of Notice 2018-26, but none of these was adopted in the Proposed Regulations. The rejected comments included the following requests:

- that the anti-avoidance rule not apply to the extent a reduction in tax liability by reason of Section 965 is offset by an equal amount of tax increase pursuant to a different Code Section;
- that there be a de minimis exception to the anti-avoidance rule;
- that the rule disregarding changes to methods of accounting not apply when the change is from an impermissible method of accounting to a permissible one, and that a principal purpose test should apply; and
- that the “specified payment” rules in 1.965-4(f) be expanded to cover other transactions that could lead to double counting and double non-counting in the computation of post-1986 earnings and profits of a specified foreign corporation.

Foreign Tax Credits (Sections 1.965-5 and -6)

- Section 965(g)(1) provides that no credit is allowed under Section 901 for the applicable percentage of any taxes paid or accrued (or treated as paid or accrued) with respect to any amount for which a Section 965(c) deduction is allowed (i.e., the deduction granted to arrive at the appropriate 15.5% or 8% effective rate of tax on the Section 965 inclusion amount).
 - The Proposed Regulations clarify that “taxes paid or accrued” refers to foreign income taxes paid or accrued directly by the taxpayer under Section 901 (1.965-5(b)), and that “taxes treated as paid or accrued” includes (i) foreign income taxes deemed paid by the taxpayer under Section 960, (ii) foreign income taxes allocated to an entity under Treasury Regulations Section 1.901-2(f)(4), and (iii) a distributive share of taxes paid by a partnership (1.965-5(c)(1)(i)).
 - The Proposed Regulations also clarify that a U.S. Shareholder’s applicable percentage can change from one Section 958(a) U.S. Shareholder inclusion year to another (1.965-5(d)(1)).

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Election, Payment, and Other Special Rules (Section 1.965-7)

Under Section 965(h)(1), a U.S. Shareholder of a DFIC may elect to pay the net tax liability under Section 965 in eight installments. Section 1.965-7 of the Proposed Regulations includes several rules related to this election:

- The unpaid portion of the remaining 965(h) installments becomes due on the occurrence of an “acceleration event.” (1.965-7(b)(3)(i)). The Proposed Regulations add several events to the definition of acceleration events, including any exchange or other disposition of substantially all of the assets of a taxpayer, any event that results in a person no longer being a U.S. person, any event that results in a person that was not a member of a consolidated group becoming a member of a consolidated group, and any event that causes a consolidated group to cease to exist or to no longer file a consolidated return (1.965-7(b)(3)(ii)(B), (D)-(F)).
- The occurrence of certain acceleration events will not cause the remaining 965(h) installments to become due if certain conditions are satisfied and the transferee and transferor enter into a “transfer agreement” that satisfies certain requirements, including a statement that the document constitutes an agreement by the transferee to assume the liability of the transferor for the unpaid installment payments under Section 965(h) (the “eligible Section 965(h) transferee exception”) (1.965-7(b)(3)(iii)).

Affiliated Groups (Including Consolidated Groups) (Section 1.965-8)

- Section 1.965-8 of the Proposed Regulations provides for the coordination of the general provisions of the Proposed Regulations with rules applicable to affiliated groups, including consolidated groups. These rules generally provide that all members of a consolidated group that are Section 958(a) U.S. Shareholders of a specified foreign corporation are treated as a single U.S. Shareholder for purposes of a number of calculations and elections under the Proposed Regulations (1.965-8(e)(1)).

Applicability Dates (Section 1.965-9)

- The Proposed Regulations apply beginning the last taxable year of a foreign corporation that begins before January 1, 2018, and with respect to a U.S. person, beginning the taxable year in which or with which such taxable year of the foreign corporation ends (1.965-9(a)).

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ENDNOTES

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- ⁱ The formal name for the Act is “An act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018.”
 - ⁱⁱ See Notice 2018-07, 2018-4 I.R.B. 317; Notice 2018-13, 2018-6 I.R.B. 341; and Notice 2018-26, 2018-16 I.R.B. 480; see also Rev. Proc. 2018-17, 2018-9 I.R.B. 384.
 - ⁱⁱⁱ The Proposed Regulations do not provide a similar rule allocating a portion of year-end compensation that accrues after the November 2, 2017 measurement date to the period prior to November 2, 2017. Accordingly, such compensation continues not to be taken into account for purposes of calculating “post-1986 earnings and profits” as of the November 2, 2017 measurement date.

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