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Industry Directive #2 on Section 965 Foreign Earnings Repatriation

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

Large and Mid-Size Business Division

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MEMORANDUM FOR INDUSTRY DIRECTORS
DIRECTOR, PREFILING AND TECHNICAL GUIDANCE
DIRECTOR, FIELD SPECIALISTS

FROM: Barry B. Shott /s/ Barry B. Shott
Deputy Commissioner International (LMSB)

SUBJECT: Tier I Issue – Section 965 Foreign Earnings
Repatriation Directive #2

On October 2, 2007, the Deputy Commissioner, International issued a Directive

concerning the Section 965 Foreign Earnings Repatriation Issue. This second Directive is being issued to alert the field to a potential compliance issue that has been identified. An adjustment is needed under Section 965(b)(3) when a taxpayer elects to apply Revenue Procedure 99-32 to establish an accounts receivable for a Section 482 adjustment.

Background:

Section 965 provides that a corporation that is a U.S. shareholder of a Controlled Foreign Corporation (CFC) may elect, for one taxable year, an 85 percent dividends received deduction (DRD) for qualifying cash dividends received from its CFCs. There are numerous limitations and special rules applicable to the DRD, including the limitation under Section 965(b)(3). Specifically, Section 965(b)(3) requires the amount of any dividend qualifying for the dividend received deduction to be reduced if the dividend is funded, directly or indirectly, by the US shareholder. This ensures that a net repatriation of funds has been received. The statute accomplishes this goal by comparing the amount of indebtedness the taxpayer's CFCs owe to related parties on two measurement dates. The first measurement date generally is October 3, 2004. The second measurement date is the last day of the taxable year for which the taxpayer elects to utilize Section 965. If the related party indebtedness on the latter measurement date exceeds the related party debt outstanding on the first measurement date, the taxpayer is deemed to have funded some or all of the CFCs' dividends. The dividend received deduction is then reduced on a dollar for dollar basis by the increase in related party debt. This mechanism is described in the Conference Committee Report (H.R. Conf. Rep. No. 108-755, 108th Cong., 2d Sess. 1, 315 (2004), *reprinted in* 2004 U.S.C. C.A.N. 1341, 1391). The Committee Report states "This rule is intended to prevent a deduction from being claimed in cases in which the U.S. shareholder directly or indirectly (e.g., through a related party) finances the payment of a dividend from a controlled foreign corporation." *Id.* "In such a case, there may be no net repatriation of funds, and thus it would be inappropriate to provide the deduction." *Id.*

The Service issued three notices in 2005 explaining its position on Section 965 (Notice 2005-10, 2005-1 C.B. 474; Notice 2005-38, 2005-1 C.B. 1100; and Notice 2005-64, 2005-2 C.B. 471). Notice 2005-38 explains that the term indebtedness under Section 965(b)(3) has the same meaning as it does for general Federal income tax principles. Additionally, in response to taxpayer requests for clarification of the scope of the related party indebtedness rule, Notice 2005-64 explicitly provides that accounts payable established pursuant to Revenue Procedure 99-32 constitute related party indebtedness for Section 965(b)(3) purposes.

Treasury Regulation 1.482-1(g)(3) requires taxpayers to make conforming adjustments to their accounts to reflect primary and correlative allocations made under Section 482. Revenue Procedure 99-32 provides a procedure for taxpayers to make such conforming adjustments without the income tax consequences that would otherwise apply. It allows taxpayers to elect to treat the amount of a conforming adjustment as indebtedness for income tax purposes. For example, where a US parent corporation is under-compensated by its CFC, Section 482 requires a primary upward allocation of income to the US parent and a downward correlative allocation to the CFC. Revenue Procedure 99-32 allows the required repatriation of additional cash from the CFC to the US parent, mandated as a conforming adjustment, to be treated as a debt owed by the CFC to the parent. Electing to apply Revenue Procedure 99-32 enables the US parent to avoid a subsequent taxable inclusion upon the repatriation (or deemed dividend if the repatriation does not occur). An account established pursuant to section 4.01 of Revenue Procedure 99-32 is explicitly treated under the revenue procedure as interest-bearing debt. Moreover, section 10.06 of Notice 2005-64 explicitly provides that Revenue Procedure 99-32 accounts payable constitute related party indebtedness for

purposes of Section 965.

Examination Guidance:

Accounts receivable established for tax years ending after October 3, 2004 and the tax year of the Section 965 election will be treated as related party indebtedness under Section 965(b)(3). Examiners should be aware of this issue and recognize that adjustments to the computation of the Section 965 dividend received deduction will be warranted if adjustments are made under Section 482 with regard to that same taxpayer, and the taxpayer elects to apply the provisions of Revenue Procedure 99-32.

Issue Tracking:

Cases with this specific issue should be identified in the Issue Management System (IMS) with:

- Uniform Issue Locator: UIL 965.01.04 – Related Party Indebtedness
- Issue Tracking Attribute: ITA I146 – Foreign Earnings Repatriation (Sec. 965) Related Party Indebtedness

Questions regarding this directive or the development of any issues involving Section 965 foreign earnings repatriation should be directed to International Technical Advisors, Nancy Johnson (primary), Rich LaRusso (backup) or Section 965 Industry Counsel, Glenn McLoughlin or Christine Irwin.

This Directive is not an official pronouncement of law or the position of the Service and can not be used, cited, or relied upon as such.

cc: Commissioner, LMSB
Deputy Commissioner, LMSB
Division Counsel, LMSB
Commissioner, SBSE
Chief, Appeals
Director, Planning Analysis and Support

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