

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

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to: Area Counsel (Natural Resources & Construction)  
(Large & Mid-Size Business)

from: Associate Chief Counsel  
(International)

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subject: Interaction of I.R.C. § 965 and Rev. Proc. 99-32

This memorandum addresses the effect of an election under Rev. Proc. 99-32, 1999-2 C.B. 296, to establish accounts receivable in respect of an agreed I.R.C. § 482 adjustment on the I.R.C. § 965(b)(3) limitation on the temporary dividends received deduction. This advice may not be used or cited as precedent.

ISSUE

Whether an account receivable established by an election to apply Rev. Proc. 99-32 constitutes related party indebtedness under I.R.C. § 965(b)(3).

CONCLUSION

An account receivable established pursuant to an election to apply Rev. Proc. 99-32 is treated as debt for all Federal income tax purposes, including I.R.C. § 965(b)(3). We recommend that all closing agreements under Rev. Proc. 99-32 covering a taxable year in which the taxpayer elected the benefit of I.R.C. § 965 include language confirming that the account receivable established in the closing agreement constitutes related party indebtedness for purposes of I.R.C. § 965(b)(3).

LAW AND ANALYSIS

Section 422 of the American Jobs Creation Act of 2004, P.L. 108-357, added new I.R.C. § 965, which provided a one-time dividend received deduction to corporate taxpayers. The provision was designed to encourage the repatriation into the United

States of earnings from controlled foreign corporations (“CFCs”) and to promote the reinvestment of those earnings in this country. The statute covers qualifying dividends received by a U.S. shareholder from a CFC. I.R.C. § 965(a)(1). Specifically, an 85% dividend received deduction is available to electing U.S. shareholders for certain cash dividends. Id. The qualifying cash dividends must be received from a CFC during the election year. Id. The dividend received deduction is subject to certain limitations and special rules. I.R.C. § 965(b) and (c). A taxpayer could elect to apply I.R.C. § 965 to either its last taxable year beginning before October 22, 2004, or its first taxable year beginning on or after that date. I.R.C. § 965(f). A U.S. shareholder was required to make an affirmative election to utilize the benefits of I.R.C. § 965 on a timely-filed return (including extensions). Id. The election was a one-time event and, for a calendar year taxpayer, could cover either the 2004 or 2005 taxable year. Id.

I.R.C. § 965 imposes several limitations on the amount of the qualifying dividend. For example, I.R.C. § 965(b)(2) limits the qualifying dividends to distributions in excess of the taxpayer’s typical dividends from CFCs as measured over a base period. This and other limits under I.R.C. § 965 reflected Congress’ intent to make the one-time dividend received deduction available only if a taxpayer was bringing additional cash into the United States to stimulate the domestic economy.

Another limit on the I.R.C. § 965 dividend received deduction is the reduction for increases in related party indebtedness. I.R.C. § 965(b)(3) requires the amount of any dividend qualifying for the dividend received deduction to be reduced by any increase in related party indebtedness over a period including the election year. This limitation effectively ensures that a dividend funded by the U.S. shareholder, directly or indirectly, that does not result in a net repatriation of funds is ineligible for I.R.C. § 965 benefits. The statute implements the restriction by comparing the amount of indebtedness the taxpayer’s CFCs owe to related parties on two measurement dates. The first measurement date is October 3, 2004. The second measurement date is the last day of the taxable year for which the taxpayer elects to utilize I.R.C. § 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 qualifying dividend used to compute 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, 108<sup>th</sup> Cong., 2d Sess. 1, 315 (2004)). 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. In such a case, there may be no net repatriation of funds, and thus it would be inappropriate to provide the deduction.” Id.

The Treasury Department and the IRS issued three notices in 2005 addressing the implementation of I.R.C. § 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). Section 7.02(a) of Notice

2005-38 explains that the term “indebtedness” under I.R.C. § 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, section 10.06 of Notice 2005-64 explicitly provides that accounts payable established pursuant to Rev. Proc. 99-32 constitute related party indebtedness for I.R.C. § 965(b)(3) purposes.

Treas. Reg. § 1.482-1(g)(3) requires taxpayers to make conforming adjustments to their accounts to reflect primary and correlative allocations made under I.R.C. § 482 and contemplates that such conforming adjustments might include the treatment of allocated amounts as dividends or capital contributions, as appropriate, and contemplates further that repayments of allocated amounts might be made without further income tax consequences to the extent provided in revenue procedures. In this regard, Rev. Proc. 99-32 provides a procedure for taxpayers to make such repayments of allocated amounts. Rev. Proc. 99-32 allows taxpayers to elect to treat the amount of a conforming adjustment as indebtedness for income tax purposes. For example, where a U.S. parent corporation is under-compensated by its CFC, I.R.C. § 482 requires a primary upward allocation of income to the U.S. parent and a downward correlative allocation to the CFC. Rev. Proc. 99-32 allows the conforming adjustment required under Treas. Reg. § 1.482-1(g)(3) to be treated as debt owed by the CFC to the U.S. parent corporation and the repatriation of additional cash from the CFC to the U.S. parent to be treated as a repayment of that debt. Electing to apply Rev. Proc. 99-32 enables the U.S. parent to avoid a taxable inclusion upon the repatriation.

Section 4.01 of Rev. Proc. 99-32 specifies the terms of the debt in pertinent part as follows:

*.01 Account, interest, currency, and payment.* If a United States taxpayer qualifying under section 3 complies with the requirements of section 5, such taxpayer (or any member of the affiliated group within the meaning of section 1504(a) of the Code in which such taxpayer is included) shall be permitted to establish **an interest-bearing account receivable** from, or payable to, the related person (being a corporation as defined in section 7701(a)(3) of the Code) from, or to, whom the section 482 allocation is made with respect to a controlled transaction in an amount equal to the primary adjustment for each of the years in which an allocation is made . . . . The account shall:

- (1) be deemed to have been created as of the last day of the taxpayer's taxable year for which the primary adjustment is made;
- (2) bear interest at an arm's length rate, computed in the manner provided in section 1.482-2(a)(2) of the regulations, from the day after the date the account is deemed to have been created to the date of payment. For purposes of section 1.482-2(a)(2)(iii), where applicable, **the account shall be considered to be a loan or advance** having a term extending from the day after the date the account is deemed to have been created through the expiration of the 90-day period required in section 5 . . . .

(3) be expressed, both as to principal and interest, in the functional currency of a qualified business unit . . . .

(4) be paid within the 90-day period required in section 5, or treated as prepaid by offset prior to that time as provided in section 4.02 . . . . **Any such payment within the 90-day period, and any such prepayment prior to that time pursuant to section 4.02, shall be treated as a payment of the account for all Federal income tax purposes, regardless of its characterization under foreign law . . . .**

*[Emphasis added.]*

An account receivable established pursuant to a taxpayer election under Rev. Proc. 99-32 is treated under the revenue procedure as interest-bearing debt. The account is deemed created on the last day of the taxable year for which the primary adjustment was made and accrues interest from the following day forward. The requirement to accrue interest confirms the appropriate treatment of the account receivable as debt for Federal income tax purposes. See Estate of Mixon v. United States, 464 F.2d 394, 409 (5<sup>th</sup> Cir. 1972); Baker Commodities, Inc. v. Commissioner, 48 T.C. 374, 398 (1967), aff'd on other grounds, 415 F.2d 519 (9<sup>th</sup> Cir. 1969); Kolkey v. Commissioner, 27 T.C. 37, 61 (1956), aff'd, 254 F.2d 51 (7<sup>th</sup> Cir. 1958). Moreover, the revenue procedure specifically treats the payment of the account as a repayment of an account receivable for all Federal income tax purposes, and therefore debt for all Federal income tax purposes. Because the account established by the taxpayer's election is treated as debt for all Federal income tax purposes, the taxpayer may not make an inconsistent characterization for purposes of I.R.C. § 965. The Treasury Department and the IRS confirmed in Notice 2005-64 that Rev. Proc. 99-32 accounts payable constitute related party indebtedness for purposes of I.R.C. § 965. Thus, taxpayers were on notice of the need to take into account the I.R.C. § 965 consequences when deciding whether to elect to establish accounts receivable under Rev. Proc. 99-32 for the I.R.C. § 965 election year.

Treating Rev. Proc. 99-32 accounts receivable as related party debt for purposes of I.R.C. § 965(b)(3) is consistent with the policies underlying I.R.C. § 965. A U.S. corporation that undercharged its CFC for goods and services has effectively shifted its funds offshore, to the same extent as if it had loaned cash to its CFC that was used to pay an arms-length price. If the U.S. taxpayer elects to establish an account receivable under Rev. Proc. 99-32, the cash that was paid or payable to the U.S. parent for income tax purposes is in the hands of the CFC and must be repaid according to the terms of the debt in the same manner as if the U.S. parent had in form made a loan at the time of the undercharge. Accordingly, the related party indebtedness limitation of I.R.C. § 965(b)(3) should apply to the electing taxpayer in exactly the same way as it would apply to a taxpayer that, in form, made a loan.

In order to preclude disputes on this issue, we recommend adding the following language to any closing agreements under Rev. Proc. 99-32 relating to an I.R.C. § 482

adjustment that results in a Rev. Proc. 99-32 account receivable during a taxable year for which the taxpayer elected the benefits of I.R.C. § 965:

Any intercompany account receivable established by the taxpayer pursuant to this closing agreement will be considered related-party indebtedness for all purposes of the I.R.C. including, but not limited to, section 965(b)(3).

However, failure to include such language in no way renders an account receivable anything other than related-party indebtedness for all purposes of the Code.

In addition, we recommend that closing agreements relating to the I.R.C. § 965 deduction not be concluded prior to the conclusion of any examination that might result in an I.R.C. § 482 adjustment and election under Rev. Proc. 99-32 that could impact the I.R.C. § 965 amount. To the extent timing issues necessitate the signing of an I.R.C. § 965 closing agreement before resolution of outstanding I.R.C. § 482 issues, language should be included in the I.R.C. § 965 agreement providing for a reduction in the qualifying dividend used to compute the dividend received deduction for any increase in related party indebtedness resulting from a subsequent election under Rev. Proc. 99-32 made by the taxpayer.

Please call (202) 622-3850 if you have any further questions.