DEPARTMENT OF THE TREASURY
Office of Public Affairs

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FACT SHEET:

Second Notice Providing Guidance on Repatriation of Foreign Earnings Under the American Jobs Creation Act

Overview:
Today the Treasury Department and IRS announced the second in a series of notices that provide detailed guidance for U.S. companies that elect to repatriate earnings from foreign subsidiaries subject to the temporary reduced tax rate available under the American Jobs Creation Act (AJCA). The notice released today provides guidance to companies on what constitutes a qualifying dividend, the impact of mergers and acquisitions and issues related to the section 78 gross-up.

Background
Internal Revenue Code section 965, enacted as part of the AJCA in October 2004, is a temporary provision that allows a U.S. company to repatriate earnings from its foreign subsidiaries at a reduced effective tax rate provided that specified conditions and restrictions are satisfied. Section 965 provides that a U.S. company may elect, for one taxable year, an 85 percent dividends received deduction for eligible dividends from its foreign subsidiaries giving it an effective 5.25 percent tax rate on qualifying dividends.

In January 2005, Treasury and IRS issued a notice (Notice 2005-10) that provided guidance to companies on the domestic reinvestment plan requirement under the new provision. The notice specified permitted investments in the United States for which the repatriated funds may be used under this provision. The notice announced today (Notice 2005-38) provides additional guidance on the amount of dividends that qualify for the dividends received deduction. Further, Treasury and the IRS announced their intention to issue a third notice that will address the impact of section 965 on a corporation's computation of its tax liability.

How it works

- Under the new section 965, for one year only, companies that repatriate earnings from foreign subsidiaries and reinvest them in the United States are subject to a reduced effective tax rate on the repatriated earnings.
- Before repatriating the earnings, the company must have a domestic reinvestment plan for such earnings that is approved by the company's CEO or President and is subsequently approved by its board of directors.
- There are limits on what dividends may qualify for the deduction. A qualifying dividend must, for example, be paid in cash and exceed the amount that a company has historically repatriated from its foreign subsidiaries.

Dividends qualifying for the deduction

- ✓ The qualifying dividends must be paid in cash.
- ✓ The qualifying dividends must exceed the amount a company has historically repatriated from its foreign subsidiaries.
- ✓ Qualifying dividends may not exceed the greater of $500 million or the amount a company has previously reported on its financial statement as permanently reinvested overseas.
- ✓ The amount of dividends otherwise qualifying for the deduction is reduced to the extent of the total debt outstanding from the foreign subsidiaries to related parties at the end of the company's election year exceeds the amount of debt owed by its foreign subsidiaries to related parties on October 3, 2004.
- ✓ The amount of the dividends must be invested in the United States in accordance with an approved investment plan (as outlined in Notice 2005-10).

Historical Threshold of Repatriations

The dividends that qualify for the deduction must be extraordinary in that they exceed the amount that a company has historically repatriated. The notice provides guidance on how to define the historical threshold above which dividends may qualify for the deduction.

- ✓ In general, a domestic company must determine its threshold repatriation level based on the annual average repatriations by its foreign subsidiaries during the five most recent taxable years ending prior to June 30, 2003, taking out the high and low years.

- ✓ The repatriations by a foreign subsidiary during the five most recent taxable years ending prior to June 30, 2003 are treated as a tax attribute of a domestic company that owns such foreign subsidiary. Accordingly, this attribute remains with the domestic company upon the sale of its stock.

Maximum Repatriations

- ✓ In general, the statute limits the maximum repatriations qualifying for the deduction to the greater of the amount of earnings permanently reinvested overseas as indicated on its financial statement or $500 million.

- ✓ To the extent the earnings reported as permanently reinvested overseas are attributable to the foreign subsidiaries held by a domestic company, these amounts are treated as a tax attribute of such company. Accordingly, this attribute remains with a domestic company upon the sale of its stock.

Related party indebtedness

- ✓ The amount of dividends otherwise eligible for deduction under section 965 must be reduced by the amount of the increase in related party debt between October 3, 2004 and the last day of the election year.
- ✓ This rule is intended to prevent a deduction from being claimed in cases in which a domestic company directly or indirectly finances the payment of a dividend from a foreign subsidiary.
- ✓ The notice provides detailed rules on how certain transactions after October 3, 2004 may effect the general rules for calculating a foreign subsidiaries indebtedness to related persons for purposes of section 965.

Sec. 78 gross-up

- ✓ Under section 78 of the Internal Revenue Code, a U.S. company is required to include in its income an amount of foreign taxes it is deemed to have paid during the taxable year.
- ✓ Section 965 does not allow a foreign tax credit, including the foreign taxes deemed paid, for the deductible portion of the dividend.
- ✓ The notice provides that a section 78 gross-up does not apply to any foreign tax for which a foreign tax credit is disallowed under section 965.

QUESTIONS AND ANSWERS

When is the provision effective?
The provision generally applies to the first taxable year beginning on or after the October 22, 2004 enactment (which would, for example, mean 2005 for calendar-year taxpayers). Alternatively, the provision could be applied to the preceding taxable year (which means 2004 for calendar-year taxpayers).

Exactly what is the tax reduction to companies on the foreign earnings they repatriate?
The U.S. company is permitted to deduct 85% of the qualifying repatriated dividends. If the company is subject to the 35% corporate tax rate on the other 15% of the repatriated amount, that represents effectively a 5.25% tax rate on the total repatriated dividend.

Do firms have to use the tax break in 2005 or could they save it and use it in later years?
The provision applies only for the year specified and cannot be used in later years.