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Final IRS Regulations Sync Section 956 with TCJA Participation Exemption – Limits “Deemed Dividends” for U.S. Corporate Shareholders of CFCs

Tax Talks on **May 30, 2019**

Implements 2018 Proposed Regulations, ending most limitations on investments in U.S. property, as well as pledges and guarantees by CFCs wholly-owned by U.S. corporations – also provides PTI guidance for CFC shareholders.

EXECUTIVE SUMMARY

In anticipated and important guidance, the U.S. tax authorities have issued final regulations under I.R.C. Section 956 (the “New 956 Regulations”).[1] The New 956 Regulations are intended to eliminate, in most situations, the “deemed-dividend” issue with respect to controlled foreign corporations (“CFCs”) that are subsidiaries of U.S. corporations, including where the U.S. domestic corporation is a partner in a partnership.

The New 956 Regulations achieve this result by generally giving a U.S. corporation’s income inclusions under Section 956 the same benefit of the U.S.’s limited participation exemption[2] that is otherwise available to actual dividends received from a CFC. The impact of Section 956 on noncorporate U.S. entities (which generally do not benefit from the participation exemption), including where the noncorporate entity is a partner in a partnership, is generally unchanged by the New 956 Regulations. The New 956 Regulations finalize, with limited but important changes, proposed regulations from November 2018.

An immediate impact of the New 956 Regulations will be on the use of non-U.S. subsidiaries to secure borrowings by U.S. corporations. A U.S. borrower generally should now be able to grant lenders complete pledges of stock of CFCs and provide full security interests in the assets of CFCs (and so-called CFC Holdcos — *i.e.* borrower subsidiaries that hold CFC stock) as long as the CFCs are directly or ultimately owned, in whole, by U.S. domestic corporations and partnerships where all of the direct and indirect partners are either U.S. domestic corporations or entities not subject to U.S. income tax (*e.g.*, tax-exempts, foreign investors) without negative U.S. federal income tax consequences. Under existing Section 956 regulations, the effective limit to avoid phantom dividend income was a pledge of 65% of the voting stock in the CFC, with no guarantee by the CFC. The New 956 Regulations should end the position that new loan agreements must include the old, limited 65% voting stock pledge to protect U.S. corporate borrowers – which was an arguable residual concern while the regulations were still proposed.

The New 956 Regulations also provide a welcome change for multinationals with substantial previously taxed income ("PTI") under the CFC rules relating to certain hypothetical distributions under the ordering rules for PTI.

These final regulations were issued and became effective on May 23, 2019 (with lookback effectiveness to taxable years beginning after December 31, 2017 in certain circumstances).

Please contact any Proskauer tax lawyer, or your usual Proskauer contact, for further information about the New 956 Regulations and their effect on shareholders of CFCs, as well as lenders and borrowers in structures with non-U.S. subsidiaries or operations. A detailed description of the New 956 Regulations, along with background, a description of the U.S. tax authorities' explanation of the provisions and discussion of differences from the proposed regulations, continues below.

Background and Context

The New 956 Regulations, issued by the U.S. Treasury Department ("Treasury") and the Internal Revenue Service (the "IRS"),[3] finalized proposed regulations published on November 5, 2018[4] (the "Proposed 956 Regulations").

A “United States shareholder”[5] of a CFC[6] generally must include its pro rata share of the CFC’s undistributed earnings attributable to an investment in “United States property” (such income amount, a “Section 956 deemed dividend”) in computing its U.S. taxable income.[7] The rule had broad application under the prior regulations, and a deemed dividend would arise from actual investments by the CFC in the United States (e.g., a related party loan to a domestic affiliate), as well as through actions deemed to constitute an indirect U.S. investment – namely guarantees by a CFC and pledges of more than 2/3 of the CFC’s voting stock (or any of its assets) to secure a United States shareholder’s debt.[8] The rule was intended to subject to current U.S. income tax investments of CFC earnings that were “substantially the equivalent of a dividend” – as under prior law, an actual dividend distribution from a CFC to a taxable U.S. shareholder (regardless of its identity) was fully subject to U.S. tax.

The Tax Cuts and Jobs Act, however, changed the treatment of distributions by a CFC to a corporate United States shareholder. The new law introduced a modified form of participation exemption, which allows a U.S. corporation to deduct distributions by CFCs of foreign-source earnings that would otherwise be taxable as dividends in computing U.S. corporate income tax.[9] The Act, however, did not substantially modify Section 956.

In the preamble to the Proposed 956 Regulations, the Treasury and the IRS acknowledged the misalignment between the participation exemption result with respect to actual distributions from a CFC and the Section 956 deemed dividend inclusion resulting from investment in United States property. The Proposed 956 Regulations provided that United States shareholders of a CFC that are exempted U.S. corporations would not be required to include a Section 956 deemed dividend in income resulting from shares it owns in that CFC (such amount, the “tentative Section 956 amount”) to the extent that such Section 956 deemed dividend would be excluded from income if it was paid as an actual distribution under Section 245A (a “hypothetical distribution”).[10] The intent of the Proposed 956 Regulations was to harmonize the treatment of deemed inclusions with actual distributions under the TCJA participation exemption.

The New 956 Regulations

The New 956 Regulations largely mirror the Proposed 956 Regulations – both in their general harmonizing of Section 956 and the TCJA participation exemption as well as the limitations on this benefit to foreign-source dividends. Specifically, only the foreign-source portion of a dividend a corporate United States shareholder receives from a CFC is generally eligible for the participation exemption under Section 245A. If a CFC has U.S.-source earnings (for example, earnings attributable to U.S.-source dividends paid to a CFC or U.S. effectively connected income earned by a CFC), a portion of its Section 956 deemed dividend may still be subject to current U.S. income tax. Additionally, non-corporate United States shareholders continue to be subject to current U.S. income tax on any Section 956 deemed dividend just as under prior law – which is again consistent with the TCJA participation exemption being available only to corporate United States shareholders.

The Proposed 956 Regulations are discussed in detail in our prior publication (which can be accessed here).

There are two substantial, albeit technical, changes in the New 956 Regulations from the Proposed 956 Regulations. One relates to the treatment of U.S. partnerships with U.S. corporate partners for purposes of the TCJA participation exemption. The second relates to the allocation of an actual distribution amount to prior earnings and profits ("E&P") of a CFC under Section 959(c), which is critical for tracking the treatment of current and future distributions (whether actual or deemed).

U.S. Corporate Partners in U.S. Partnerships that hold CFC stock

The New 956 Regulations provide rules on the treatment of U.S. partnerships that are United States shareholders of a CFC. The preamble to the Proposed 956 Regulations discussed two possible approaches – reducing the Section 956 deemed dividend amount of a U.S. partnership that is a United States shareholder of a CFC by the amount of the deduction for which its U.S. corporate partners would be eligible on a hypothetical distribution under the TCJA participation exemption, or determining the amount of the Section 956 deemed dividend at the U.S. partnership level without regard to the status of its partners but only a U.S. corporate partner's distributive share of the Section 956 deemed dividend would potentially not be taxable.[11]

The New 956 Regulations include provisions implementing the first approach. As a result, under the New 956 Regulations:

1. A U.S. partnership must compute its tentative Section 956 amount, then
2. The U.S. partnership then reduces that tentative Section 956 amount by the aggregate of the deductions that would be allowed to its U.S. corporate partners under the TCJA participation exemption on a hypothetical distribution.[12]

The New 956 Regulations also provide that the portion of a Section 956 deemed dividend amount allocable to a partner is determined by multiplying the U.S. partnership's Section 956 deemed dividend amount by the "net hypothetical distribution income of the partner" (i.e., the hypothetical distribution to the partner less the TCJA participation exemption deduction to which the partner would be entitled) over the aggregate of such amount for all partners.[13]

Section 959(c) Allocations to Prior E&P

Section 959(c) provides ordering rules for allocating a distribution amount (both actual distributions and Section 956 "deemed" inclusions) among E&P of a CFC.[14] The main purpose of these ordering rules is to track PTI of a CFC and to apply the rules which generally prevent the current taxation of a CFC's E&P that had been previously included in U.S. taxable income.

Prior to the New 956 Regulations, the ordering rules under Section 959(c) first allocated a distribution to prior years' E&P of the CFC that have already been subject to U.S. income taxation under Section 956 (such E&P, the "Section 956 PTI"), then to prior years' E&P of the CFC that have already been subject to U.S. income taxation under Section 951(a)(1)(A), and then to other E&P of the CFC.[15] Without a specific rule providing otherwise, a hypothetical distribution under the Proposed 956 Regulations would first be allocable to the Section 956 PTI amount, and a distribution of Section 956 PTI is not included within the scope of the TCJA participation exemption.[16] As a result, the allocation of the hypothetical distribution to Section 956 PTI would not reduce the Section 956 deemed dividend inclusion. This treatment of a hypothetical distribution is also inconsistent with how a Section 956 deemed dividend inclusion would be allocated under the ordering rules.[17]

Treasury and the IRS acknowledge this issue in the preamble to the New 956 Regulations,[18] and the New 956 Regulations include an overriding ordering rule when applying Section 959(c) rules to a hypothetical distribution – in essence, providing that none of a hypothetical distribution would be attributable to the Section 956 PTI.[19] This treatment is also consistent with the allocation of a Section 956 deemed dividend to a CFC's E&P under Section 959– and also furthers the broader intent of the New 956 Regulations, which is harmonizing the results under Section 956 with the effect of the TCJA participation exemption. This should make tracking of PTI by large multinational groups easier, and avoid unexpected mismatches, but care will still need to be taken – especially in situations involving CFCs with earnings that are not eligible for the TCJA participation exemption.

Effective Date Provisions

The New 956 Regulations apply to shareholders of a CFC for the CFC's taxable years beginning on or after July 22, 2019. However, consistent with the Proposed 956 Regulations, taxpayers may apply the New 956 Regulations to tax years beginning after December 31, 2017, provided that the taxpayer and U.S. persons that are related to the taxpayer consistently apply the New 956 Regulations to all their CFCs.[20]

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[1] Unless otherwise stated, all Section references are to the U.S. Internal Revenue Code of 1986, as amended.

[2] Section 245A, added as part of the 2017 tax law (Pub. L. No. 115-97), commonly known as the Tax Cuts and Jobs Act ("TCJA").

[3] T.D. 9859, 84 Fed. Reg. 23716 (May 23, 2019).

[4] REG–114540–18, 83 Fed. Reg. 55324 (Nov. 5, 2018).

[5] A "United States shareholder" of a controlled foreign corporation generally means any U.S. person that is a 10% or more owner of the voting power or value of the CFC. Section 951(b).

[6] A “controlled foreign corporation” is a non-U.S. corporation more than 50% of the total combined voting power or the total value of the stock of which is owned by one or more United States shareholders. Section 957(a).

[7] Section 956(a).

[8] Treasury Regulation Section 1.956-2(c).

[9] *See* generally Section 245A.

[10] The tentative Section 956 amount for a United States shareholder is determined for each taxable year of a CFC and the hypothetical distribution is deemed to be made on the last day during the taxable year in which the foreign corporation is a CFC. Treasury Regulation Section 1.956-1(a)(2)(i).

[11] 83 Fed. Reg. at 55327.

[12] Treasury Regulation Section 1.956-1(a)(2).

[13] Treasury Regulation Section 1.956-1(a)(2)(iii).

[14] Section 959(a) provides the general rule excluding PTI from income under Section 951(a), and cross-references to Section 959(c) for relevant ordering rules in applying the exclusion.

[15] Section 959(c).

[16] Section 245A(a) specifically allows the deduction for a “dividend,” which generally is a distribution of current and accumulated E&P of a corporation and generally does not include a distribution of PTI.

[17] Under Section 959(f)(1), a Section 956 deemed dividend is treated as attributable first to earnings and profits previously taxed under Section 951(a)(1)(A) and then to other earnings and profits of the CFC. Therefore, no amount of Section 956 deemed dividend is attributable to Section 956 PTI.

[18] 84 Fed. Reg. at 23716.

[19] Treasury Regulation Section 1.956-1(a)(2)(ii)(C).

[20] Treasury Regulation Section 1.956-1(g)(4).

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