Chapman and Cutler LLP

Chapman Client Alert

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Current Issues Relevant to Our Clients

# New Proposed Regulations Take the Bite out of Section 956 Deemed Dividends for Corporate Shareholders

New treasury regulations proposed by the IRS on October 31 significantly diminish the sting of Section 956 for many US corporations that own stock in non-US corporations that have investments in US property. In order to match a new dividend-received deduction under the Tax Cuts and Jobs Act (the "TCJA") available to corporate taxpayers who receive actual non-US-source dividends, these proposed regulations reduce the tax impact of the deemed dividend that corporate shareholders would have otherwise received due to Section 956.

The new proposed regulations have not been finalized. Although language in the preamble to the proposed regulations indicates that taxpayers may begin to rely on the proposed regulations even though not yet final, many taxpayers may choose to wait until the regulations are finalized.

## Background: The New Participation Exemption and Historical Rules on 956 Inclusions

Effective for distributions after December 31, 2017, new Section 245A allows corporations a 100% deduction for the non-US-source portion of dividends received from certain 10-percent owned non-US corporations. In other words, new Section 245A allows US corporations not to pay US tax on many dividends from foreign corporations. This "participation exemption" is allowed to US corporations that are 10% (or greater) shareholders of the non-US corporation making the distribution, other than passive foreign investment companies ("PFICs"). The non-US-source portion of the dividend is determined by calculating the non-US portion of the non-US company's undistributed earnings compared to the total undistributed earnings of the non-US company. The non-US-source portion of the undistributed earnings is the portion which is neither (i) from a trade or business of the CFC that is effectively connected with the United States, nor (ii) a dividend received by the CFC from a US corporation that is 80-percent (or greater) owned by the non-US corporation. Since a deduction is allowed in the same amounts as the dividend, no foreign tax credit associated with the dividend is allowed. Also, the deduction is not allowed in respect of certain hybrid dividends.

In contrast, Section 956 was intended to cause US persons to pay tax on certain "deemed" dividends from non-US corporations. Generally, Section 956 causes a US shareholder to have an income inclusion if it is a 10-percent (or greater) shareholder in a controlled foreign corporation (a "CFC") and if that CFC holds an investment in US property. A CFC is a non-US corporation that is owned more than 50% (by vote or value) by US shareholders holding 10% or more (by vote or value of the CFC). An "investment in US property" includes (i) direct investments in US property, (ii) loans to its US parent, (iii) guarantees of, and pledges of collateral for, loans to its US parent, and (iv) pledges of more than two-thirds of the voting stock of the CFC or pledges of the assets of the CFC to support loans of the US parent. Therefore, non-US corporations that are controlled by US parents have historically avoided providing credit support for third party loans to their direct or indirect US parents.

## Disparate Treatment Between Actual and Deemed 956 Dividends

After the TCJA, there was disparate treatment between actual non-US-source dividends received by US corporations and deemed dividends resulting from the application of Section 956. Actual non-US-source dividends would be eligible for the new 100% deduction under the Tax Cuts and Jobs Act, but deemed dividends caused by Section 956 would not. In contrast, the actual non-US source dividends would not be eligible for the non-US tax credit, but the deemed dividends caused by Section 956 would. With the recent US corporate tax rate now below the corporate tax rate of many jurisdictions, the deemed dividends would often also not be subject to US tax after the tax credit. If the income from the non-US subsidiary would otherwise be subject to the new corporate minimum tax on world-wide income, the US parent group might actually save US taxes by creating a deemed dividend to avoid the minimum tax.

The IRS, citing their broad regulatory authority under Section 956 and their longstanding practice of conforming the application of Section 956 to its purpose, introduced the proposed regulations to address this disparate treatment.

## Proposed Rule to Conform the Effect of Section 956 Inclusions

To achieve parity of treatment between actual dividends and deemed dividends, the proposed regulations reduce the Section 956 inclusion for a US corporate shareholder by the amount of the deduction that the US shareholder would have been allowed under Section 245A if the shareholder had received an actual dividend from the CFC. In other words, a corporate US shareholder will not have a Section 956 inclusion if the CFC's undistributed income is all foreign-source and would have been eligible for the Section 245A dividends received deduction. If the CFC's undistributed income is only partly non-US-source, then the deemed dividend under Section 956 will be reduced proportionately under the proposed regulations.

## Practice Notes

Historically, to prevent Section 956 inclusions, non-US subsidiaries have been excluded from guarantees and collateral pledges and the pledge of the voting equity of the non-US subsidiaries has been limited to two-thirds of the total voting equity. However, under these proposed regulations and the other weakening of Section 956 under the TCJA, it may no longer be necessary to exclude foreign subsidiaries from the guarantee and collateral structure in cross-border transactions. It is important to note, however, that the proposed Section 956 relief discussed above applies only to corporate tax paying entities and does not provide any benefit in structures using pass-through entities (LLCs, L.P.s, etc.).

Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs) are not eligible for the dividend received deduction under Section 245A and therefore are not eligible for the reduction to the Section 956 inclusion under the proposed regulations.

The extended holding period that applies to the non-US-source dividends under Section 245A also applies to the reduction in the Section 956 inclusion under the proposed regulations. The holding period requirement is that the taxpayer must hold (or own indirectly) the stock of the CFC for more than 365 days during the 731 day period beginning 365 days before the last day during the taxable year in which the non-US corporation is a CFC.

Taxpayers who had affirmatively planned into Section 956 inclusions in order to access creditable non-US taxes paid by their CFCs may no longer be able to use that strategy when the proposed regulations take effect.

## Effective Date

The text of the proposed regulations state that they will apply to taxable years of CFCs beginning on or after the date the regulations are finalized. The preamble provides more leeway by stating that taxpayers may rely on the proposed regulations for tax years of a CFC beginning after December 31, 2017 and for tax years of a US shareholder in which such taxable years of the CFC end. Regardless, the taxpayers must consistently apply the proposed regulations if they choose to apply them. Some taxpayers may choose not to apply the new proposed regulations because guidance in the preamble generally has less authority than guidance in the regulations themselves.

## For More Information

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