SULLIVAN & CROMWELL LLP

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IRS Issues Proposed Regulations on Section 956

Proposed Regulations Would Reduce Amounts Subject to U.S. Taxation for Certain U.S. Corporate Taxpayers

On October 31, 2018, the Internal Revenue Service (the "IRS") and the Treasury Department released proposed regulations (the "Proposed Regulations") to provide guidance on the operation of Section 956 of the Internal Revenue Code (the "Code") in light of the participation exemption system adopted under the Tax Cuts and Jobs Act (the "Act").

Section 956 operates alongside the subpart F regime to subject certain income of controlled foreign corporations ("CFCs") to U.S. taxation when such income is effectively repatriated to the United States through the CFC's investment in "United States property," which includes, for example, any tangible property in the United States, stock of a U.S. corporation or any obligation of a U.S. person.[1]

The Proposed Regulations provide that an amount otherwise included in U.S. taxable income under Section 956 is reduced by the deduction a U.S. corporate shareholder would have been allowed under Section 245A if the amount had been received as a distribution from the CFC.[2] The Proposed Regulations would effectively eliminate Section 956 inclusions for U.S. corporate parents of foreign subsidiaries to the extent that dividends received from such foreign subsidiaries would not have been subject to U.S. federal income tax on account of the new 100 percent deduction for dividends under Section 245A.

This means that U.S. corporate borrowers might more readily be able to pledge the stock or assets of foreign subsidiaries to support a borrowing. In this regard, taxpayers will generally be able to rely on the Proposed Regulations for taxable years beginning in 2018 (except in the case of foreign subsidiaries with a November 30th taxable year). It may be complex to determine in particular cases whether a dividend would otherwise have been fully eligible for the 100 percent deduction, and other considerations might also come into play. Limitations on the pledging of foreign assets in connection with corporate borrowings should therefore not be eliminated without consulting tax counsel.

This also means that once the regulations are finalized, U.S. corporate taxpayers may not be able to rely on Section 956 as a potential tool for crediting so-called "excess" foreign tax credits (*i.e.*, credits in excess of what would have been needed to offset the U.S. tax on the resulting income inclusion and might therefore have been used to offset U.S. tax on other foreign source income in the same limitation basket). While most corporate taxpayers have already included pre-2018 earnings and credits in income under Section 965 of the Code, this tool could still be relevant for foreign taxes that accrue in taxable years beginning after 2017 and before the Proposed Regulations are finalized.

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ENDNOTES

1 I.R.C. § 956(c) (2012). Section 956 is intended to ensure that taxpayers are subject to U.S. taxation upon such effective repatriations as if they had repatriated the CFC's funds through dividends, thereby granting similar treatment for dividends from and for certain investments in United States property by CFCs. In December 2017 through the Act, Congress adopted a new Section 245A of the Code, which permits a 100 percent deduction equal to the foreign-source portion of any dividend received by a U.S. corporation from a "specified 10-percent owned foreign corporation." A "specified 10-percent owned foreign corporation" is defined as a CFC or a foreign corporation that has at least one corporate U.S. shareholder, in which "U.S. shareholder" means any U.S. person owning at least 10 percent of the vote or value of such foreign corporation. Under this Section 245A then, a corporate U.S. shareholder is effectively not taxed on a dividend from a CFC due to the offsetting deduction in that section, but the same taxpayer would not be entitled to any similar deduction with regard to amounts subject to U.S. taxation due to Section 956.

2 Prop. Treas. Regs. § 1.956-1(a)(2).

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