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International Tax ADVISORY ■

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Inexplicably, Section 956 Survives Tax Reform Intact

Section 956 was enacted by the Revenue Act of 1962 as part of the legislation that introduced the Subpart F and controlled foreign corporation regimes into the federal income tax law. After being in effect for more than 50 years, many thought that Section 956's days were numbered. In the tax reform legislation drafted by both the House Committee on Ways and Means and the Senate Finance Committee, Section 956 was to be repealed for domestic corporations (not individuals) as a result of each committee's proposals to overhaul the international tax regime. To the surprise of many, the final version of the Tax Cuts and Jobs Act signed into law on December 22, 2017, did not repeal Section 956 for corporations that are U.S. shareholders.

Basics of Section 956

Under Section 951, a U.S. shareholder that directly or indirectly owns stock of a controlled foreign corporation (CFC) generally must include in its gross income the sum of: (1) its pro rata share of the CFC's Subpart F income for the year; and (2) the amount determined under Section 956 for the year. Section 956 provides that a U.S. shareholder must generally include in its gross income its pro rata share of the amount of the CFC's "United States property" held by that CFC at the close of each quarter, limited to the CFC's "applicable earnings." The amount is the basis.

For this purpose, the term "United States property" means any property (if acquired after December 31, 1962) that is tangible real or personal property located in the United States, stock of a domestic corporation, an obligation of a U.S. person, or a right to use a patent, copyright, invention, secret formula, or similar property in the U.S. if it was acquired or developed by the CFC for such use. Excluded from this definition are, among other things, bank deposits, U.S. bonds and money, certain debts arising in the ordinary course of business from the sale or processing of property, certain property used in transporting persons or property in foreign commerce, and an amount equal to certain pre-1963 earnings and profits. The term "applicable earnings" means the current and accumulated earnings and profits of the CFC, reduced by distributions and by previous inclusions from Section 956. Additionally, the amount of the U.S. shareholder's Section 956 investment in United States property income inclusion is subject to further reductions under the previously taxed income rules of Section 959 to the extent that the CFC has accumulated earnings attributable to Subpart F income inclusions.

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In drafting Section 956, Congress provided that when a CFC acquires United States property, the CFC's U.S. shareholders would be treated as if the purchase price for the United States property first had been distributed to them as a cash dividend and then contributed back to the CFC in order to purchase the property. At the time, the Senate Finance Committee stated that the earnings of a CFC invested in United States property should be "taxed to the [U.S.] shareholders on the grounds that this is substantially the equivalent of a dividend being paid to them."

Effect of the Tax Cuts and Jobs Act

Perhaps the single biggest update to the U.S. international tax regime made by the Act is the move from a worldwide system of tax to a territorial one by establishing a participation exemption. The Act provides domestic C corporations an exemption, or a 100% dividends received deduction (DRD), for foreign-source dividends from "specified 10%-owned foreign corporations" for tax years of foreign corporations beginning on or after January 1, 2018. The DRD would also apply to amounts treated as dividends under Section 1248 on the sale or exchange by a domestic corporation of stock in a foreign corporation held for at least one year.

Both the House and Senate versions proposed participation exemption provisions similar to the provisions contained in the final version of the Act. The drafters of the House and Senate versions believed that the inclusion of the participation exemption provisions made it unnecessary to continue applying Section 956 to domestic corporations. The section-by-section summary that accompanied the House version explained that Section 956 should be repealed because the new provisions would remove disincentives for investment of foreign earnings in the U.S. As a result of the participation exemption provisions, the House Committee on Ways and Means stated that "no U.S. tax would be avoided by a U.S. parent corporation reinvesting earnings of its foreign subsidiary in United States property rather than distributing those earnings."

Although the final version of the Act generally adopted the participation exemption provisions proposed in the House and Senate versions, the final version did not repeal Section 956 of the Code. The conference committee did not provide any explanation for this deviation from the House and Senate versions. This deviation has left many people scratching their heads given that the policy considerations cited by the House Committee on Ways and Means are still relevant as a result of the final version of the Act. Because the final version of the Act did not repeal Section 956, a U.S. shareholder must continue to include in gross income its pro rata share of a CFC's investments in U.S. property in addition to Subpart F income and global intangible low tax income (GILTI).

In the post-Act world, Section 956 will probably have a more limited scope of application than it did previously. Other international provisions in the Act will create large amounts of previously taxed income for many corporations. Some CFCs will have significant amounts of previously taxed income as a result of the new Section 965, which requires all U.S. shareholders to include in income their share of the accumulated post-1986 deferred foreign earnings of all "deferred foreign income corporations." Additionally, the GILTI inclusions will create a significant amount of previously taxed income for some corporations. All of this previously taxed income will reduce any Section 956 amount.

Section 956 will continue to limit a taxpayer's ability to invest CFC assets in U.S. property. While a U.S. shareholder would continue to be taxed on a CFC's investments in U.S. property, the payment of an actual dividend would seemingly be tax free due to the DRD.

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