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# Plot Twist – Proposed Regulations Mean Section 956 Did Not Actually Survive 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 40 years, many thought that Section 956's days were numbered. When the Tax Cuts and Jobs Act of 2017 (TCJA) rolled out new international tax rules for corporate taxpayers reflecting a shift from a worldwide system of tax to a territorial one, yet left Section 956 untouched, many were left scratching their heads. Why was Section 956 – which restricts effective repatriations of earnings through investments by certain foreign corporations in certain United States property – left unchanged? It now appears that the Treasury Department and IRS had the same question. In proposed Treasury regulations released on October 31, 2018 (Proposed Regulations), the IRS acknowledged that in light of the new participation exemption system, retaining Section 956 in its current form for domestic corporations would be inconsistent with its purpose of taxing actual and effective repatriations in the same manner.

## Mechanics of Section 956 Before the Proposed Regulations

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."

For this purpose, the term "United States property" means any property that is tangible real or personal property located in the U.S., 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.

Congress determined that certain investments by a CFC of its earnings in United States property are "substantially the equivalent of a dividend" and enacted Section 956 to provide consistent treatment for actual dividends and certain investments in United States property constituting effective repatriations (i.e., so-called "deemed dividends").

## Confusion Following the Enactment of the Tax Cuts and Jobs Act

Perhaps the single biggest update to the U.S. international tax regime made by the TCJA is the move from a worldwide system of tax to a territorial one by establishing a participation exemption. The TCJA 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 TCJA. 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. Although the final version of the TCJA generally adopted the participation exemption provisions proposed in the House and Senate versions, the final version did not repeal Section 956 of the Code. This deviation 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 TCJA.

It seems that the Treasury Department and IRS were also left scratching their heads about why Section 956 was left intact. In the preamble to the Proposed Regulations, the Treasury Department and IRS explain that "as a result of the enactment of the participation exemption system, the current broad application of section 956 to corporate U.S. shareholders would be inconsistent with the purposes of section 956 and the scope of transactions it is intended to address." The Treasury Department and IRS explained that Section 956 applied appropriately to domestic corporations before the TCJA because both dividends from, and investments in United States property by, CFCs were included in income by such domestic corporations. However, under the participation exemption system, earnings of a CFC that are repatriated to a corporate U.S. shareholder as a dividend are usually effectively exempt from tax because the U.S. shareholder is generally afforded an equal and offsetting DRD under Section 245A. On the other hand, a Section 956 inclusion of a corporate U.S. shareholder is not eligible for the DRD under Section 245A. As a result, the Treasury Department and IRS explained that the application of Section 956 to corporate U.S. shareholders of CFCs after the enactment of the TCJA "would result in disparate treatment of actual dividends and amounts 'substantially the equivalent of a dividend'—a result directly at odds with the manifest purpose of section 956."

## Impact of the Proposed Regulations

The Treasury Department and IRS drafted the Proposed Regulations to conform the application of Section 956 to its purpose.

To harmonize with the participation exemption system, the Proposed Regulations reduce the taxable Section 956 amounts of domestic corporations that are 10% U.S. shareholders in CFCs to the extent such shareholders would also qualify for relief under the new participation exemption system if such amounts had been actually distributed. For all other classes of U.S. shareholders in CFCs that are ineligible for the new participation exemption system, such as U.S. individuals (including those that make an election to be taxed as a corporation under Section 962), regulated investment companies, and real estate investment trusts, Section 956 remains unchanged.

The Proposed Regulations provide special rules for indirect ownership. When a U.S. shareholder owns shares of the CFC indirectly (within the meaning of Section 958(a)(2)), unless the hypothetical distribution is subject to Section 245A(e) (which provides special rules for "hybrid dividends"), the hypothetical distribution is generally treated for purposes of Sections 245A, 246(a), and 959 as if the corporate U.S. shareholder directly owned the CFC. In order to determine whether the hypothetical distribution is considered a hybrid dividend, the distribution is treated as if it were made to the U.S. shareholder through each intermediary entity. To the extent Section 245A(e)(2) would apply, the U.S. shareholder is treated as not being allowed a deduction under Section 245A by reason of the hypothetical distribution.

The Proposed Regulations will minimize the effect of Section 956 on certain cross-border financial transactions. The Proposed Regulations will presumably be welcome news for lenders who have often accepted more limited pledges and guarantees of a corporate borrower's foreign subsidiary stock and such subsidiary's assets than preferred in order to avoid the borrower-adverse tax-consequence risk from a deemed repatriation under Section 956. Because Section 956 is curtailed only for borrowers that are domestic corporations, most standard lending documentation will presumably retain the Section 956 concepts and definitions, but as amended to no longer include corporate U.S. shareholders of CFCs.

The Proposed Regulations are also welcome news for some taxpayers because they will allow some corporate U.S. shareholders to more easily access cash held by their CFCs that would have otherwise resulted in Section 956 inclusions (subject to federal income tax at the 21% rate). However, the Proposed Regulations are less welcome news for certain taxpayers seeking to affirmatively trigger a Section 956 inclusion to access creditable foreign taxes paid by their CFCs.

The changes in the Proposed Regulations apply to taxable years of CFCs beginning on or after the date final regulations are published. However, taxpayers can rely on the Proposed Regulations for taxable years of CFCs beginning after December 31, 2017, provided that such taxpayers and related U.S. persons apply the Proposed Regulations consistently to all CFCs in which they are U.S. shareholders.

The Treasury Department and IRS are requesting comments on the application of the Proposed Regulations to domestic partnerships that are U.S. shareholders of CFCs, as well as comments on the maintenance of previously taxed earnings and profits accounts under Section 959, basis adjustments under Section 961, and the interaction of the Proposed Regulations with Section 245A(e).

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