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CLIENT ALERT

IRS Finalizes Regulations Under Section 956

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On May 22, 2019, the Internal Revenue Service ("IRS") finalized regulations clarifying circumstances under which certain U.S. corporations will not be taxed on "deemed dividends" under Section 956.[1] The finalized regulations generally mirror the proposed regulations issued on October 31, 2018 and provide guidance on the application of such rules in the context of partnerships with corporate partners and certain ordering rules.

Prior to the regulations, Section 956 required a U.S. corporation that owned a foreign corporate subsidiary to include in income, as a dividend, any amount the foreign corporation was treated as investing in U.S. property. This rule impacted borrowing by U.S. multinational corporations because a guaranty by a foreign subsidiary of the debt of a U.S. parent was treated as an investment in U.S. property that resulted in such a deemed dividend. As a result, it is common for loans to U.S. based multinationals to exclude guarantees by non-U.S. subsidiaries of the U.S. parent's debt.

The Tax Cuts and Jobs Act of 2017 provided a participation exemption for U.S. corporate shareholders receiving distributions from foreign corporations in which they hold a 10% or greater interest. This exemption allows a corporate shareholder to benefit from a dividends received deduction, effectively exempting such dividends from taxation. Deemed dividends under Section 956 could therefore be subject to taxation under circumstances where an actual dividend would be received tax-free. This disparate treatment is addressed by the proposed regulations.

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1 All references are to the Internal Revenue Code of 1986, as amended.

The regulations exclude Section 956 amounts from income to the extent an actual dividend could be received tax-free under the participation exemption. The final regulations also provide guidance on determining Section 956 inclusions where Section 956 amounts are received by a U.S. partnership that has at least one U.S. corporate partner.

Under this guidance, the Section 956 amount received by the partnership will be reduced by the amount of the Section 245A deduction to which any such corporate partners would be entitled. Any remaining Section 956 amounts are then allocated among all partners under a hypothetical distribution in proportion to net income, in a manner intended to ensure that corporate partners are only allocated the portion of their ratable share that would not have qualified for a Section 245A deduction. The non-corporate partners for which the Section 245A deduction is unavailable should thus be allocated the portion of the Section 956 inclusions that is not reduced by Section 245A deductions.

The final regulations are applicable with respect to controlled foreign corporations (“CFCs”) as of any tax year beginning on or after July 22, 2019, and to the taxable years of U.S. shareholders in such CFCs in which or with which such taxable years of the CFCs end; accordingly, the final regulations will be effective as of January 1, 2020, for calendar-year taxpayers. However, taxpayers may apply the final regulations to taxable years beginning after December 31, 2017, if all related entities (determined under Section 267 or 707) apply the final regulations consistently.

Generally, once the final regulations are effective, foreign subsidiaries of U.S. corporate borrowers should be able to provide guarantees of parent debt, and pledge assets in support of parent debt, without adverse U.S. tax consequences. Borrowers should review their existing credit agreements because they may only provide an exclusion of foreign guarantees and pledges to the extent of adverse tax consequences. Once effective, the regulations may eliminate the adverse tax consequences and therefore require foreign guarantees and pledges to be put in place.

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