Simpson Thacher

Memorandum

IRS Proposed Regulations Significantly Limit the Applicability of Section 956 Income Inclusions

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On October 31, 2018, the IRS issued proposed regulations (the "Proposed Regulations") that generally will allow U.S. corporations that are U.S. shareholders of controlled foreign corporations ("CFCs") to avoid the impact of Section 956 of the U.S. Internal Revenue Code of 1986 (the "Code"). This change may result in CFCs being able to provide credit support to U.S. borrowers without the adverse U.S. tax consequences which have historically applied.

Section 956 Background

Section 956 was intended to prevent avoidance of U.S. taxation through indirect repatriation of the earnings of a CFC to the U.S. where the actual repatriation of such earnings through a dividend would have given rise to U.S. income tax. Section 956 generally requires income inclusions similar to imputed dividends to direct or indirect 10% U.S. shareholders of a CFC to the extent of the CFC's investment of earnings in U.S. property. For these purposes, an investment in U.S. property includes direct or indirect guarantees by a CFC of the obligations of a U.S. borrower, and pledges of more than 66% of the voting stock of such CFC in support of the obligations of a U.S. borrower. To avoid Section 956 inclusions, credit support of U.S. borrowers by CFCs has generally been limited.

The Tax Cuts and Jobs Act of 2017 (the "TCJA") created a mismatch in treatment of actual dividends from CFCs for certain U.S. shareholders and imputed dividends under Section 956. New Section 245A gives a U.S. corporation a deduction equal to the foreign-source portion of any dividend actually received from a foreign corporation with respect to which it is a 10% U.S. shareholder. The practical result of this participation exemption system is that a foreign corporation (including a CFC) generally can pay a dividend to a corporate 10% U.S. shareholder without the shareholder being subject to U.S. tax. The TCJA did not provide for a corresponding exemption for Section 956 inclusions of a corporate 10% U.S. shareholder, even though an actual dividend would generally not be subject to U.S. income tax.

Proposed Regulations

The Proposed Regulations provide that a U.S. corporation can generally reduce the amount of any Section 956 inclusion that would otherwise apply to the extent the U.S. corporation would be entitled to a deduction under Section 245A if such amounts were actually distributed to the U.S. shareholder by the CFC at the end of the CFC's taxable year. Because Section 245A gives a deduction only to U.S. corporations, other U.S. shareholders, such as individuals, will continue to be taxed on Section 956 inclusions. Additionally, corporate U.S. shareholders will continue to be taxed on Section 956 inclusions if a deduction under Section 245A is unavailable due to holding period requirements or other rules.

Although the Proposed Regulations are effective when finalized, the Preamble states that taxpayers may rely on the Proposed Regulations for taxable years of a CFC beginning after December 31, 2017 so long as the taxpayer and any related persons consistently apply the Proposed Regulations with respect to all CFCs of which they are 10% U.S. shareholders.

Practical Implications

The Proposed Regulations are a welcome change and may eliminate the need (from a U.S. tax perspective) to impose restrictions on the credit support that CFCs can provide to U.S. borrowers in certain instances. As discussed above, however, U.S. borrowers may not always be eligible for the exclusion under Section 245A with respect to all CFCs, and borrowers should consider their specific situations in designing credit support packages. In addition, taxpayers (especially those implementing structures which cannot be easily modified) should consider further whether to rely on the Proposed Regulations given it is unclear if and when such regulations will actually be finalized in their current form.

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